

CURRENCY AND COMMERCE

A SURVEY OF FUNDAMENTAL PRINCIPLES
AND
THEIR APPLICATION TO INDIAN PROBLEMS

BY

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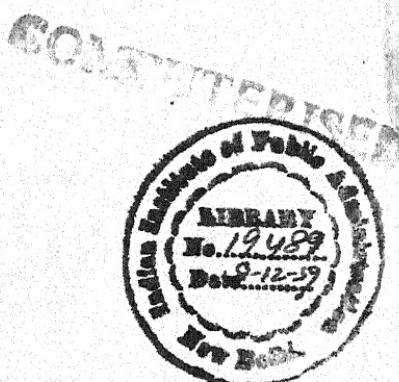
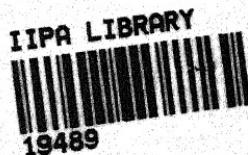
and Author of "The Indian Money Market", etc.

WITH A

FOREWORD

BY

SIR J. C. COYAJEE, kt.



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FOREWORD

IN the present work the author has supplied a useful and lucid introduction to the important economic topics of Currency, Banking and International Trade for the Indian students as well as for our general public. Any one who contributes to the clarification of thought on these pivotal matters certainly performs a public service. The book will be the more useful to our college students and general readers because it aims at emphasising the changes in monetary, banking and trade policies which form the characteristic feature of the post-War period. It is indeed a fascinating study on which the student of these matters is entering, and he may be sure that he will amply be rewarded for the sustained exertion that he will have to put forth. Meanwhile, I shall proceed to notice briefly some of the topics dealt with by Prof. Sharma.

The author has put in a plea for stabilisation and for the restoration of the International Gold Standard under proper and suitable conditions. He has also discussed some of the defects of the substitutes for the Gold Standard. That standard has in its favour not only psychological supports and sanctions but also the great advantages which it possesses on the international side. In fact the strongest defence of the standard lies on the side of its international significance and functioning. Even the Sterling *bloc* countries, which are in such an advantageous position otherwise, are still anxious to return to the Gold Standard. The future lies not with the dethronement or abandonment of the Gold Standard, but on the side of its better management and further development. For, indeed, the Gold Standard has shown itself most elastic and capable of very great development. In particular, the proposals of Mr. Keynes and others for the "Variable Gold Standard" have opened up new potentialities of management—the gold parity being varied according to the state of national and international price-levels.

Our author has devoted a section to the Purchasing Power Parity Theory. That remarkable theory has already had a long and interesting theory ever since its enunciation by Prof. Cassel. The theory has assumed a Comparative as well as an Absolute form—which it is very necessary to distinguish—while Cassel himself has greatly modified the earlier form in which his theory was cast. The utility of the theory as a first approximation has certainly survived all adverse criticism; but it is obviously necessary that the theory should be applied with caution.

Prof. Sharma has done well to give a special chapter to the functions and importance of the Bank for International

Settlements. That bank has been expanding its functions under the stress of economic circumstances, and it bids fair to become the focus of co-operation on the part of the central banks of the world. The movement towards such co-operation was necessitated by the desirability at once for interchange of services and of avoiding friction. But such co-operation can go much further and can be of immense use to the world not only on the banking side but by improving monetary policy and standards. Thus many of the defects which have latterly crept into the Gold Exchange Standard can be eliminated by the co-operation of central banks, while the International Gold Standard can be assisted in the matter of its restoration through the same agency. Thus, such an authority on currency matters as Sir Walter Layton has envisaged the possibility of placing the task of regulating the long-period value of gold in the hands of the Bank for International Settlements; and Dr. Einzig has shown how that bank can help in either steadyng or raising the world price-level. The same author has indeed brought forward the idea of a "world bank-rate" and has made suggestions for the regulation of the rates of interest to be charged by the Bank.

Special attention has also been drawn in the book to the effects of the Ottawa Agreement and the Indo-British Trade Pact. The author has presented the reader with both sides of this controversial matter; but he has taken care to add that the progressive substitution of the Indian linseed for the Argentine article in the British market "is an outstanding achievement of the Ottawa Agreement". Quite apart from the details of any particular agreement or pact, we have to note the general economic advantages of a policy which secures to a raw material producing country like India a preferential footing in such a great and comparatively steady market as Great Britain—especially in times like the present. For we can take it that other countries producing raw materials have been and will be developed on scientific lines and, therefore, India will in future be constantly exposed to newer and stronger competition in that economic sphere which she has dominated in the past.

In conclusion, it is to be hoped that our students as well as general readers will benefit by the labours of Prof. Sharma, and will be led on to study the authoritative works on the topics which he has treated carefully and clearly. Before the student who follows this advice there lies that highly fascinating, though necessarily controversial, literature which has grown up during the post-War period on the subjects of Currency, Banking and International Trade.

BOMBAY,
August, 1935.

J. C. COYAJEE.

PREFACE

THE object of this book is to present the elementary principles of banking, currency, finance, credit, etc., in as clear and simple a manner as possible. Educated persons who have not before made any systematic study of these subjects are expected to get a clear idea thereof with the help of this book. Though designed in this sense for beginners, it does not gloss over difficulties or avoid severe reasoning.

A special feature of the book lies in a treatment of the fundamental principles in relation to Indian problems. Thus topics like international trade, imperial preference, free trade and protection, etc., have received the attention of the author in respect of their bearing upon Indian problems also.

In the post-War period, great changes have taken place in the domain of trade, money, currency, etc., which have notably affected the views held regarding the gold standard; central banking policy; international trade; imperial preference and trade depression. Many of the principles connected with these topics have received new importance in theory and practice; and the author has taken care to analyse them in a clear perspective.

In a volume of this kind it is necessarily impossible to give that amount of attention to many of such matters as trade depressions, gold standard, international trade, which is commensurate with their great importance at the present time. It is also clearly impossible to give an exhaustive discussion of such topics as the imperial preference issue, which are highly controversial, and which are indeed the cause of much mystification to the general reader and even to business men. It is, however, hoped that the consideration given to these problems will make the volume of service and of interest, not only to the student, but also to the layman and to the business man and the industrialist.

Though the subject is in parts highly controversial, the following chapters are not intended to advocate or to attack any particular cause. The aim of the author has throughout been to discuss the controversial topics in impartial terms, and to make the argument intelligible to the general reader.

The Indian nationalistic views have by no means been ignored, but they have received the amount of attention without fear or favour, which they deserve in a volume of this kind. Thus controversial questions have been approached with absolute impartiality and moderation, and the author has attempted to maintain the necessary 'objectivity of vision and evenness of temper'; while the aim has been to be accurate rather than exciting.

The book is primarily intended to be a text-book for University and college students preparing for commerce as well as for arts examinations of various Universities on the subject; but it should also prove useful for business men as well as for industrialists.

Many of the chapters were read in draft form by Prof. Kalka Prasad Bhatnagar, M.A., Professor of Economics and Vice-Principal of the local D. A. V. College, who offered most helpful suggestions, while Prof. Kalishanker Bhatnagar, M.A., Vice-Principal of the S. D. College, Cawnpore, once again generously helped in the revision of the proofs. For all this practical assistance the author tenders his deepest thanks to them.

The author is deeply indebted to Prof. Sir J. C. Coyajee, Kt., University Professor of Economics, Andhra University, for his learned Foreword, which has, indeed, added immensely to the usefulness of the book.

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K. K. SHARMA.

CHAPTER I

Importance of Money

IN modern times money plays a very important part in every aspect of the life of people and their prosperity is closely bound with its use. We live in the age of money economy. We purchase goods through money, pay to domestic servants through money and discharge all our obligations to others through money. We also get money in exchange for services rendered or goods sold to others. The effect of the conveniences and benefits of money is felt in every aspect of the life of society and of individuals. Domestic or internal trade and international or foreign trade are carried on with the help of money. In the absence of money, it would have been impossible to carry on the tremendous volume of trade, inland as well as foreign. A slight change in the value of money causes a great disturbance in trade. Modern society is fairly familiar with the evil effects of changes in the value of money upon trade, commerce and industry. The world has not yet recovered from the after-effects of the changes that took place in money value during the war.

Company promotion, partnership business, declaration of bonuses and dividends to employees and shareholders respectively, floating of loans by governments, private and public corporations and individuals—all such operations are rendered possible with the help of money. The governments of the various countries of the world would not be able to discharge their sundry functions without the help of money.

It can be said that our all-round progress depends upon money. Yet we seldom reflect upon its historical importance and realize its all-round influence upon our social, political and economic life. It is but natural that when people are habituated to the use of a certain institution or thing, they regard it as usual with them and do not ordinarily think of the consequences which might arise if they were deprived of it. Thus even though money is closely involved in our day-to-day life, an ordinary individual seldom pauses to note its importance, much less understand how he would be affected by a change of the monetary system. Though used by everybody, money is not easily understood by all. Its problems and difficulties are too knotty and complex to be followed clearly even by experts.

A proper understanding and knowledge of the monetary system is very necessary to purge it of its evils and disadvantages which very often arise unknown, unseen and unexpected.

Since the introduction of money, people of all ages and climes have tried to understand it properly and to work it out systematically into practice. But they have not always succeeded in their legitimate aims of doing away with the evils commonly associated with the working of the medium of exchange. It has been due in the past to a lack of clear knowledge of monetary science that society has had to face difficulties.

It is not possible to overstate the importance of money. It is really an epitome of the history of civilization and is an index of the economic progress of people. As civilization advances, wants of people grow in variety and number and the monetary system adjusts itself semi-automatically as it were to changed circumstances. In a community with division of labour little developed, having limited number of wants, money is simple and inexpensive, but nonetheless necessary. In primitive economy when production is for local consumption, trade is confined to neighbouring towns, production is not indirect and roundabout, money is simple and credit is but little developed. Transactions are mostly carried on on a strictly cash basis. As trade develops, industry and commerce increase and business becomes relatively complex and expensive, the system of medium of exchange also undergoes corresponding changes. It becomes very costly and expensive. When incomes are small, payments are for very low amounts and a very cheap commodity serves as money; but when incomes increase and a country becomes very rich, divided into many classes of people from the point of view of their earnings, a variety of commodities, some of which may be costly and others cheap, begin to serve as money. Industrial development can be measured by the system of exchange which serves the needs and requirements of industries and commerce.

Money dispenses with the double coincidence of wants by generalising consuming power. It enables people to make their claims upon society in the most suitable form and is, therefore, productive of great economies in consumption and avoids waste. In the system of barter when there is direct exchange of commodities for commodities there is a great waste owing to lack of some common measure of values of commodities which is avoided by the use of money. Money is a commodity in universal demand and its owner is always confident that it will be accepted without demur or delay by others in exchange for their commodities. In case of barter, the owner of a commodity not in universal demand cannot be sure of the fact that his commodity can be so accepted and suffers a good deal owing to lack of general passableness of his commodity. People cannot, therefore, make the best use of their natural resources in the absence of money. Money, therefore, affects

a great advantage by generalising the spending power of people, by enabling them to know what they want and to what extent do they want a particular commodity.

Money increases production by facilitating exchange of commodities and by promoting specialization. Division of labour increases greatly with the use of money; for people can specialize themselves in the production of commodities for which they are best fitted by their natural endowments and technical training. With the help of money, they are assured of putting a correct valuation on their commodities and of being able to exchange them for money whenever they want to do so. In the absence of a common medium of exchange, production cannot be high, because specialization cannot take place to a large extent. Everybody has to produce many commodities for himself and cannot easily barter them away for those he may require. But money increases production by obviating such disadvantages. Greater specialization, improvement in trade, commerce and industry, production in anticipation of demand and good use of natural resources of a country depend upon the system of exchange in vogue. The latter affects them and is in turn affected by them. The capitalistic system of production fostered by competition and the system of private property involving mass production of machine-made goods, leading to all-round progress, cannot be possible without a corresponding efficiency of the system of exchange. Hence division of labour, growth of factories, specialization of machinery, storing of goods and a large sale of commodities are at once the consequences and causes of an expensive medium of exchange.

Money gives the necessary mobility to capital and is responsible for the concentration of capital into the hands of those who are best able to utilize it in an effective manner. Real capital consists of the actual instruments of production—buildings, docks, railways, godowns, steamships, plant, machinery, raw materials, etc. It is these things which increase production of consumable goods and it is these things which are required by the entrepreneurs of industries for organizing production. Money gives a command over such goods and is invested in such goods in a place where they are very productive. Through the instrumentality of money capital flows from a place where it is less productive to a place where it is more productive. This process seems automatic for when buildings are dilapidated through constant use and machinery becomes worthy of being thrown on the heap of rubbish, capital may be invested elsewhere and not in the same place if the latter is not very remunerative. But at the back of all these processes is the judgment of the investors. Thus money gives a proper degree of mobility to capital in this sense.

Concentration of capital is also possible through money. Those who cannot organize production and are unable to start businesses of their own can lend it to others who are able to do so. Thus capital is attracted by joint-stock companies and bankers from all possible sources and utilized for increasing production. It is, therefore, through money that loans can be contracted to be repaid in future. Savings which result in the creation of capital are made possible through money only; for commodities cannot be saved directly as they deteriorate very soon and he who puts by commodities directly for future use is not sure of retaining their value. Therefore money is helpful from this point of view in encouraging savings through the stimulus of the rate of interest.

Money in the past has also been responsible for the growth of social and political freedom by substituting freedom of contract and competition for custom and status. When rent, wages and prices are paid in kind, they are generally determined by status and custom as in the Middle Ages in Europe and in India and many other countries even to the present day. Under such circumstances, labourers and cultivators suffer a good deal. The latter are liable to arbitrary exactions on the part of the landlords and do not feel interest in work. But as money is substituted for payments in kind, they are sure of retaining the fruits of their labour for themselves and feel an air of freedom. The influence of the introduction of money economy was beneficial for the serfs in Europe for as they paid rents in money, they were actuated to work more. Payment of taxes also in money brought about political freedom. People felt the payment of taxes when money went out of their pockets and they had a tendency and a will to see that the proceeds of taxation were utilized for their benefit. They wanted to have a voice in the control of civic affairs and began to realize their rights and responsibilities and made the Executive who spent the proceeds of taxation to realize the force of their demands gradually but steadily.

In England and other countries, the influence of money economy proved very beneficial. In the absence of money economy in the Middle Ages, wages were paid according to the Truck System, i.e., in commodities. This led to great social abuses. When labour was paid in kind, rotten stuff at very high prices was given to the labourers. The Truck Acts making it compulsory for employers to pay wages in money resulted in the social improvement of the labourers. In India also in the villages the influence of the introduction of money payments for payments in kind is being felt and is improving the condition of the village artisans and agricultural labourers.

Money also creates national and political solidarity. The isolation of the village in Russia and India is being broken up

by many causes among which the influence of money is by no means of small importance. Improved communications connecting villages with towns are enabling village people to import commodities from outside for which payments are made in money and they can also sell their produce in cities for money. Villagers, therefore, depend upon outside places for their trade. They are influencing those places and are in turn being influenced by them. They feel their interests bound up with an all-round progress. This has been responsible for the creation of national solidarity in the West as well as in India. Villagers come into contact with outside people and appreciate their ideas. The break-up of the isolation of the village in India and a realization of the interdependence of towns and villages resulting in mutual goodwill and co-operation is not an unworthy achievement for which money economy is to a certain extent responsible.

Money is thus important from many points of view and the economic and material progress of people is closely associated with it. It is consequently very desirable and necessary that monetary science should be properly understood and appreciated in its proper perspective. A wrong monetary policy may plunge society into unfathomable difficulties which bring universal chaos and disorder in their train. In the past, society has had to face the consequences of positively wrong monetary policies of financiers and statesmen. Many laws relating to monetary problems existing on the statute books of various countries only go to show that the difficulties have been due to the adoption of a wrong policy. As already mentioned, during the last Great War disturbances in monetary and currency matters caused havoc and subjected various countries to disadvantages and dangers from which many of them have not yet recovered.

In the interest of business stability it is necessary that the value of money should remain fairly stable. An absolute stability in the value of money is not possible; but changes should be reduced to the minimum. Violent and long-continued changes in the value of money disturb businesses, upset trade and commerce and turn expected profits into losses. The relations between debtors and creditors are disturbed and speculation of the worst type is fostered which demoralises businessmen.

It is true that the monetary system is always attended by certain evils which cannot be entirely done away with but can be reduced considerably. The monetary system of exchange promotes inequality in the distribution of income and is responsible for the concentration of property into the hands of the capitalist classes. It is also responsible for the Competitive Wage System which is disadvantageous in many ways.

from the workers' point of view. As it has promoted capitalism, it is also responsible for the evils and disadvantages associated therewith. Changes in its value are bound to take place which are conducive to many social and economic evils. But nonetheless its advantages far outweigh its disadvantages. It is true that some of its evils cannot be done away with ; but they are the price which society has to pay for the manifold advantages of money. Other evils can be removed and to the extent that they can be removed the general interests of mankind require that they should be tackled in the right spirit. The monetary system oils the wheels of progress and makes the utmost satisfaction of human wants possible to a greater extent than could be done without money. Monetary science, therefore, should be correctly understood and money and monetary policy should be properly controlled in the general interests of mankind. There is no nobler work for the enlightened humanity to-day than that of controlling money and monetary policy in the general interests of society.

CHAPTER II

Evolution and Functions of Money

THE process of evolution by which men have gradually come to use precious metals as money or the common medium of exchange is very interesting; because it explains the history of the development of civilization and shows how what are commonly known as precious metals have come to be regarded as money. It is generally accepted that in primitive times there was little use of money and that generally commodities were directly exchanged for commodities. With the development of trade, commerce and industry, money largely and widely came into use. It is also accepted that as the disadvantages of a commodity, commonly serving as the medium of exchange at a particular time, were realized, another and a better commodity began to be used as money. This generally accepted explanation of the origin and development of the system of exchange is largely a matter of guess. Those who have given an explanation of the early history of money have not in their possession sufficient and reliable literature about life in primitive times. But at the same time there is a great plausibility in what they say.

The first use of money did not arise from any agreement among men. Our system of exchange also has not been evolved through successive displacements of one means of exchange by another. All have grown slowly and unconsciously from conditions which existed, in germ at least, in very early times. All the three modes of trading known to us, namely, barter, money and credit were used in primitive civilization also. The ancient Mexicans used barter and money and the Shilooks, a primitive tribe in Africa¹, used to sell goods on credit. But if barter, money and credit were used in primitive times, the word evolution applied to the system of exchange seems to be a misnomer. This is not so, for these three systems have been used in different combinations and one or the other, not to the entire exclusion of the rest, has been predominant in a particular stage of the evolution of trade and commerce. The conditions of their industrial life have determined whether, among a given people, barter or money or credit should be the most important feature of their system of exchange. Even in our own times when industrial organization is highly complex, wants are unlimited and diverse, and the mechanism of

¹ Kinley, "Money", p. 18.

exchange is highly complex, we find that barter is also prevailing. In every civilized country, farmers, etc., in villages exchange many commodities directly for other commodities.

The same is true with regard to the use of different commodities as medium of exchange at different times. The use of gold and silver as money is comparatively a late development. At first the thing accepted in exchange was necessarily some commodity which caused less inconvenience than other things used for the same purpose. Some commodity must have been in greater demand than others and the possession of that one was sure to give it the quality of general acceptability as compared with others. It must have served as a medium of exchange.

At different times different commodities have served as money or as medium of exchange. A commodity which was in universal demand served as money ; because the owner of that commodity was sure of realizing its value in terms of other goods which he required at any time. Therefore general acceptability determined the use of a commodity as money. Naturally in different stages of industry, different commodities were used as money. That one which was most convenient at a particular time was used as money. Among early nomadic tribes, cattle, sheep and other animals were naturally used as money because they were then generally desirable. They were of great convenience to their owners because they were self-portable, so to say, and could also be used to carry other forms of moveable wealth of their owners. Many other things have also been recorded as the acceptable means of exchange in primitive times, their demand depending mainly on the stage of economic life of a community. For this reason rice in certain parts of India, cacao among the aboriginal Mexicans, oil in the Ionian Islands, rocksalt in Abyssinia, tobacco in Virginia, wampum beads in New England, dates in a date country, cowry shells, etc., where these were highly valued for personal adornment served as money.² In course of time these commodities were discarded in favour of precious metals, specially gold and silver. It was because these articles became unsuitable to serve as money in times of growing trade, industry and commerce that their use as money was discarded. These former commodities have very great disadvantages. Some are inconvenient to handle and others perishable and unsuitable for storing value ; some

² The things which served as money from time to time have mainly depended upon a particular stage of economic evolution. Broadly speaking, furs and skins in hunting stage ; cattle in nomadic stage ; grain and other agricultural products in the agricultural stage and metals in the advanced economic stage have served as money.

are indivisible and heterogeneous and others are too bulky to be carried.

Thus in course of time metals came to be used as money ; for they were among the most precious things available to the semi-civilized people. Copper in Egypt and iron in Sparta are recorded to have been used as money. Gradually gold and silver came to be used as money, for they are more precious than iron and copper. They are not, however, the only precious metals and, therefore, it is necessary to consider why they should have come to be universally adopted as good material for coinage in all civilized countries of the world. There are certain qualities which an article used as money should possess in order to perform its functions to the best advantage. They may be summarised as follows :—

(1) The commodity must have large value in proportion to its bulk. Gold and silver possess a high specific value and, therefore, they are easily portable. Their value differs little from place to place, because their cost of transportation in relation to value is very small. The price of gold is roughly the same all the world over because if its supply is excessive at one place and very small at another, it would be quickly taken from the former place to the latter very cheaply. The value of gold at the mine in South Africa is less than the value of refined gold in London by a very small fraction, because it costs very little to take gold from the former place to the latter. From this point of view gold is at an advantage as compared with silver. Therefore in the U.S.A. silver dollars were replaced by paper money ; because it is very inconvenient to carry a large quantity of silver.

(2) The commodity in question should also be durable. If it is not so, it will not serve as a means of transference of value from one place to another or from time to time. Moreover it will depreciate with great use and will not bear handling well. It would result in a large loss through wear and tear. Gold and silver in their pure form rapidly wear away from usage ; but when mixed with alloy, they get the necessary durability.

(3) The commodity should also possess the characteristic of easy recognizability. All pieces should be uniform to such an extent that they can be recognized at a glance as being of a particular denomination. This quality reduces the possibility of fraud to a minimum. If it were necessary constantly to test the article offered, business would be much hindered. Gold and silver have this characteristic more than any other commodity because all pieces of gold in pure form are similar.

(4) A commodity serving as money should possess certain mechanical qualities so that it may be easily melted down,

beaten or drawn into thick or thin sheets to suit certain purposes. To put it in other words, it must be malleable. It must neither be so brittle as to break easily nor must it be so soft as not to retain the impression stamped upon it. Gold possesses this quality, but platinum does not, because the latter is a very hard metal.

(5) The commodity concerned must be divisible easily and must also be homogeneous. It must be suitable to make payments in all sums and must be exchangeable in all ratios. It must be easily divisible and aggregatable, *i.e.*, its value divisions may correspond to its physical divisions and it must be capable of being put together in a mass without any loss of value. Two small diamond pieces are not as valuable as a large one equal in weight to the two pieces. It is why diamond cannot serve as money. Gold and silver possess this quality in a high degree.

(6) The commodity must possess value. Its value may be due to its demand for money only or it may be due to its demand for uses other than the money use. But if it is demanded for other uses also, it will have a steady value. Gold and silver give a certain social position to their possessor owing to their lustre and relative scarcity. Hence they are universally desirable and possess value. Thus an article which has high specific value must be preferred to serve as money to one whose utility is merely instrumental.

(7) The commodity must also possess a stable value. In other words, its purchasing power must remain reasonably constant from place to place and from time to time. Then only it can store value and serve as a standard for deferred payments. But there is no such article which does not vary in value. These variations should be as little as possible. History has on record cases of disturbances caused in the value of silver and gold both because of increase in their supply through discoveries of new mines and also because of their supply running short of demand for them. At present the supply of gold is not keeping pace with its demand. At different times silver and gold have fluctuated in value owing to this reason. Here also gold has an advantage. Its value is likely to remain more steady because of its comparatively small annual supply, the existence of a large stock and a universal demand for it.

FUNCTIONS OF MONEY

It is necessary to define clearly the meaning of money. So far it has been referred to in broad, general terms as the medium of exchange. This is not a happy term as it includes certain things which cannot be called as money. As with most terms in Economic Science there is no very general agreement

with regard to the meaning of the term money also. Whatever view we take of the meaning of the term money, we must proceed from the determination of its functions. We must analyse and discuss these functions very carefully and in detail. The functions of money may be summarised as follows :—

(1) Money is the means or the medium of exchange, *i.e.*, it is in terms of money that the values of other commodities are expressed. The earliest service of money was to enable an individual to buy directly what he wanted. Direct exchange of commodities for commodities or in other words, the system of barter required an individual to find out a buyer for his goods in the quantities that he had to sell who had at the same time goods in as much quantity as the former wanted. Money removed this difficulty. This service of money as a means of exchange is fundamental whatever the stage of economic life ; but it is more important in the complex economic life of to-day in the civilized world. Money facilitates the division of labour by facilitating the distribution of commodities. Thus money is a general circulating medium. It performs this service because it is generally accepted. It is accepted because people know that others will take it in turn without any hitch. Its owner does not think that the ability to part with it depends on the promise of any third party to redeem it. Its success depends simply upon the fact that it is in demand for doing this work.

(2) As everything is exchanged for money, it becomes the common measure of value also. Value implies a ratio or a relation between two commodities. It is not the same thing as utility. Utility simply means the want-satisfying power of a commodity. This is subjective and, therefore, cannot be measured. Value is the ratio of exchangeability. To put it more clearly, the value of an article is what it will fetch in exchange for itself. Value, therefore, can be accurately measured. For instance, one unit of tin may be worth ten units of iron, *i.e.*, one unit of tin will buy ten units of iron. Similarly, the value of any article can be expressed in terms of any other article. But it is clear that very early in the history of civilization, mankind must have realized the benefit of having some single article by which to measure the value of other articles. Endless confusion would ensue if different people measured the values of their commodities by different articles. This common measure of values is money.

(3) Money also serves as the standard of deferred payments. All contracts which are to be fulfilled at some future time are expressed in money values though they relate to goods. If a manufacturer purchases raw materials on a month's credit, he will not return an equal quantity of raw materials at the

appointed time ; but he will pay a certain sum of money. Thus all future contracts are to be discharged in money and hence it is necessary that the value of money should remain stable ; otherwise great disturbances will be caused in businesses. Absolute stability in the value of money is an impossibility, but the changes should be confined to the minimum.

(4) Money also serves as a store of value. Some people think that an article which is storing value cannot be serving as a medium of exchange. It is a wrong view because an article cannot act as a medium of exchange unless it retains its value and retention of value is storing value. This objection would limit money to what is actually in circulation. But as a locomotive is a locomotive even if it is standing, money is money even if it is lying idle in the vaults of banks.

(5) Money apportions the product of an industry among the numerous producers and things would not go on smoothly in a stage of highly-specialized labour if money were non-existent and services were to be paid for in kind.

(6) Money enables the total satisfaction derived from spending it on different commodities to be maximum, for individuals will spend money in such a way that utility of each unit on the margin may always be the same. In the absence of money one cannot make the best use of his means.

(7) It gives the desired mobility to real capital. There is always a certain amount of capital which is actually or potentially free to move to some more remunerative employment. It can be possible if capital is in the most liquid state, *i.e.*, in the form of money.

(8) It serves as a basis of the vast superstructure of modern credit. On the strength of an adequate reserve of capital in the form of money, the structure of modern credit system is raised. Banks always keep a certain amount of cash in their reserves to meet their demand liabilities. They are not allowed to issue notes beyond a certain amount without keeping cash reserves.

The last four may be called the contingent functions of money which it has to perform only in an advanced stage of economic organization. The first four may be called its essential services which money has to perform in all stages of economic life.

These being its services, we can frame a suitable definition of money. It is, of course, very difficult to frame a definition which will conform to the different uses and at the same time may be logical. Money is commonly defined in three ways :—

(1) It is sometimes described as including all media of exchange—gold, silver, paper, cheques, bank drafts, bills of

exchange and other negotiable securities. All of them affect exchanges and all more or less obviate the difficulties of barter. But this definition is too inclusive. It includes even the media of exchange which are not general circulating media and which have even a very narrow area of circulation and are accepted because of the fact that recourse can be had to the issuer to recover payment if they fail to pass, *e.g.*, bills of exchange. Those instruments which are not generally acceptable should not be called money. Money is included in the term medium of exchange, but all media of exchange do not come under money. The scope of the term medium of exchange is much wider than that of the term money.

(2) At the other extreme is the definition which restricts the meaning of money to commodity money only. Those who advocate this view argue that an article serving as money should have value independent of its value for money use. It should be an object of direct utility ; then only it can maintain value and can properly serve as a measure of value. This is also a wrong view because an article to serve as money must have value irrespective of the fact whether its value may be due to its use as money or to its demand for uses other than those as money. If the general media of exchange of a country consist of inconvertible paper, can that country be said to be devoid of money because paper money has no demand except that it serves as money ? This definition may be clear-cut, but it is not in accordance with common usage.

(3) Between these two definitions is the view that money includes that medium of exchange which the law requires to be accepted unconditionally in discharge of debts. This will cover standard money and inconvertible paper money, if the latter is legal tender and if it can also measure value as it possesses value though it may be due to its demand for monetary purposes only. Like commodity money, its acceptance does not depend upon the credit of the issuer. According to this definition convertible paper money will be excluded from the category of money because if it is refused when offered in settlement of a debt, the holder has recourse against the issuer. This definition seems to be logical and in accordance with usage. The term money may be defined as including that part of the media of exchange which is generally acceptable in full discharge of debts and other obligations and its passableness must not depend on the action of a third party who can be called upon to redeem it in case its acceptance is refused.

CHAPTER III

Coinage

THE word coinage refers to the stamping of a piece of metal to be used as money so that its value and denomination may be known directly or by indicating its weight and fineness. The government guarantees its weight and fineness and the designs impressed upon its surface enable people to know its value.

It is only very recently that the art of coinage has attained a good deal of perfection and leaves little room for commission of frauds by dishonest people through the device of clipping them. In the past there have been various stages in the evolution of coinage as we find it now in the civilized countries of the world.

In the beginning a piece of some precious metal serving as money was probably shaped like a wedge or spike. The bars used in international payments in modern times are its representatives. They had to be assayed and weighed in order to ascertain their value. The merchants and traders who used private ingots also as coin developed the practice of placing their own marks upon them and probably made their ingots of a fixed standard of fineness. Those who had confidence in the merchants and knew their mark, only weighed the ingot and took its standard for granted.

In primitive times the coins in some cases bore resemblances to certain articles which were used as medium of exchange, for instance, in Egypt gold coins bore small images of oxen and in China of knives which recalled the previous use of oxen in Egypt and knives in China as medium of exchange. But we cannot lay down any hard and fast rule with regard to that because the modern coinage system is not a result of invention but of evolution.

Coins began to be stamped by the state gradually and the small bean-shaped coins were in use in Egypt and in China about 700 B.C. which bore punch marks in the side and they are probably the last stage before the emergence of a more or less real coin. Coins then began to be made round and flat and bore some symbols on both sides. Such were the Greek coins in the seventh century B.C. But possibilities of abrasion and dishonesty were great. The modern invention of milling the edges has been to check this dishonesty. The mechanical technique of the modern coin leaves little to be desired.

Nearly all metals have been used as coins at one time or another. Iron, copper, lead, tin, gold, platinum and others, alone or in combination, have been used for this purpose. The range of incomes and prices in a country determines the choice of the metal used as a coin. The metal of a great value will be used for this purpose if incomes and prices are high and of a low value if they are low. In modern times to meet the needs of all classes of people coins of different metals are in circulation.

We shall now consider the requisites of a good system of coinage. They are as follows :—

(1) All coins of the same denomination and value must be very accurate in composition and weight. Gold and silver coins can be durable only if they contain a certain proportion of the base metal. That is why they are mixed with alloy ; but it is very necessary that the proportion of alloy and of money metal in all pieces should be the same ; otherwise those containing a greater proportion of alloy than others would be less valuable and would cause great inconvenience. Before the development of the art of modern coinage these difficulties of difference in values of different coins of the same nominal value and of the same metal were very great because of different proportions of alloy in different coins.

(2) Coins of the same denomination should be accurate in weight. They do not pass by tale everywhere ; but only within the political boundaries of the same country and they pass by weight in discharge of foreign obligations. If, being of the same denomination, they differ in weight, the heavier ones will be picked out for melting or will be exported and this will deplete the currency of the country.

(3) Convenience of shape, size and weight is another requisite of good coinage. The best shape is that which reduces the possibility of loss from use and abrasion to the minimum. Circular coins are generally the most convenient but octagonal and oblong coins also circulate. Coins should be of such a size that they should not produce inconvenience in handling. They should be of a convenient size or weight. The four-anna pieces and two-anna pieces of silver in India were all circular and very small and inconvenient to be handled by the masses in the villages who easily lost them. Therefore their size and shape have been changed.

(4) It should be very difficult to imitate a coin in order to prevent counterfeiting, but it is impossible to attain perfection in this line. Even modern coinage can be imitated.

(5) Coins should be very durable and should be hard enough to reduce loss by abrasion to the minimum. Their

durability is promoted by putting a rim around a coin somewhat above the face so that the coin may rest on the rim when placed somewhere, for when the whole of the surface will not rest, it will lose little in fineness and weight.

(6) Cognisability is another characteristic of a good coinage. The device upon a coin should be such that people should be enabled to know at once the value and denomination of the coin. This device should not be very complex ; otherwise it will defeat its object.

To acquire all the above-mentioned characteristics, manufacture of coins has in all countries become the exclusive monopoly of the state. Its adoption by the state as its own business is the final stage in the history of coinage. The government makes coins with its own mark and fixes the weight and the standard of fineness of the coin. It also fixes its value and denomination and ordains that people shall accept coins of a certain value in full discharge of their claims.

Probably coinage did not originate with the state. But very early the state took it in its hands so that now it is everywhere done by governments. There are sound reasons for letting it remain as a state monopoly. Firstly, coins circulate among people who cannot verify the accuracy of the device on them which is a sort of certificate of their weight and fineness. If it is in private hands, devices upon it may differ and it may lead to dishonesty also. It is the state only which can obviate these difficulties and it is the one single authority in which all can have confidence. It may be said that the state can grant the exclusive right of coinage to a private monopolist ; but then the state will have to control the monopoly and this is bound to entail friction. Secondly, if coinage were left in private hands, dishonesty and frauds would become common and more rampant. The character of competition tends to sink to the level of the most unscrupulous competitor and this will perhaps hold good more in case of coinage than of any other business. The poor and the ignorant would suffer most in that case. Finally, coinage results in profits and in equity this belongs to the public and should not go to private individuals or firms. It may be said in answer to this that a private monopolist issuing the coin can be made to pay a certain form of tax on the profits of coinage ; but that will not be a good policy and besides, the government cannot get all that profit through a tax on it. It is, therefore, necessary that coinage should be the monopoly of the state.

Bullion may be converted into coinage by governments for individuals. A person may take a certain quantity of gold or silver bullion and may get it converted into coins. In such a case coinage is called *free*. A free mint keeps the coinage

right. It is clear that if the state is prepared to purchase gold in any quantity at the rate of £ 3 17s. 10½d. per ounce, nobody would sell gold for less than that price and no outsider would offer a higher price than this; for if he did so, people would sell gold to him at a profit and he would soon lower the price. Moreover why should he offer more than this amount when he can get one ounce by melting down sovereigns? When the state converts gold or silver bullion into coins on its own account, coinage is said to be limited. All token coins, i.e., coins whose real value is less than their face value are made on state account because the government makes profit on them.

The state may not charge anything from an individual who offers bullion to be converted into coins. The coinage then is said to be *gratuitous*. The government sometimes makes a charge equal to the expense incurred in manufacturing coins. This charge is known as *brassage*. If the charge exceeds the cost incurred in manufacturing coins, it is known as *seigniorage*. But this latter term is a general term used to denote the profits made by the state from coinage. The state in nearly all the advanced countries of the world exacts a charge for turning bullion into coins, but it tries to keep the charge equal to the cost incurred in manufacturing coins.

Some people argue that the state should, in all justice, recover the cost of manufacturing coins from the public. The reasons are: firstly, a good coinage system is a great convenience and, therefore, the cost of coinage should be recovered by the government from the users. Secondly, if a charge is made for coinage, coins are less likely to be exported in settlement of foreign indebtedness, because the exporters will be credited only with the bullion value of the coins and not with their face value. If coinage is gratuitous, people will export coins in settlement of foreign obligations because they will get credit to the full extent of the face value of coins. The export of coins depletes the currency and is an evil. Finally, the jewellers will not melt down coins to reconvert them into bullion because they will not submit to the loss represented by the cost of coinage.

Others argue that coinage of the standard metal should be gratuitous. Charges for coinage will vary at different mints; but the same quantity of metal will be embodied in all coins. Therefore some will be more valuable than others and with a charge the principal measure of value will not be perfect. Secondly, it is argued that if coinage is gratuitous, it will adjust itself more rapidly and easily to changes in prices than if it is not gratuitous. It is also argued that the use of coinage in a foreign country is beneficial for the trade and commerce of the home country. It serves as a sort of advertising

agency. The familiarity of the foreigners with the money of the home country will help the trade of the latter country. Coins will be accepted by the foreigners at their bullion value and the charge should be borne by the state as it will be a sort of advertisement cost. Another argument is that merchants who have to meet foreign obligations will not be prevented from exporting coins if they cannot get bullion easily and cheaply merely because the government makes a charge for coinage. The merchants then will incur some loss in exporting coins, but they will pass it on to the public in the form of higher prices for their goods. Finally, it is argued that even if coins are exported—when coinage is gratuitous—in settlement of foreign obligations, the state will not incur a great loss; because there is the chance that the balance of trade may be in favour of the country later on, and there is the likelihood of those coins being returned. Various countries hold imported coins for export in the eventuality of a turn in the tide of trade.

What is said above with regard to the expenses of coinage relates not to the subsidiary coins but to the standard or the principal money. Nearly every country requires coins of different denominations to satisfy the needs of different classes of people having different incomes. Coins of small value are required for small purchases and they are of metals of low value, their nominal value being greater than their real value.

The government of every country fixes the number of standard coins that can be minted from an ounce, say of gold or silver. How many coins shall be made out of an ounce of gold depends not upon the purchasing power of gold but upon the quantity of gold contained in the coins. This is called the mint price of gold or silver as the case may be. In England £3 17s. 10½d. were made from an ounce of gold.

In England the mint for standard coinage was free and any person could take a certain quantity of gold bullion to the mint and get it converted into coins. He was, in theory, entitled to get £3 17s. 10½d. for every ounce of gold bullion. But for turning gold bullion into coins, some time is required and he had to wait till that time. In the meantime he had to incur the loss of interest. Consequently, he would accept something less than the mint price of gold. The government there had authorized the Bank of England to buy all gold that might be offered at £3 17s. 9d. per ounce. Any one, therefore, who had bullion to convert in coins need not go to the mint. He could go to the bank, offer bullion and receive the corresponding amount of sovereigns as soon as the gold had been weighed and assayed to prove its standard. Owing to convenience and the saving of time the individuals who had to get bullion converted into coins could sacrifice 1½d. per ounce.

This implied some remuneration to the Bank for its trouble and some compensation to the government for interest on capital invested in the mint. This was also a further advantage inasmuch as it prevented over-issue of coinage because the gold lay in the vaults of the Bank uncoined till coinage was required.¹

¹ All this was changed by the Gold Standard Act of 1925 according to which bank notes became full legal tender and the holder could not get them converted into gold coins for domestic purposes. Every holder of pound notes could demand gold bullion in exchange for pound notes, but only in the form of bars containing approximately four hundred ounces troy of fine gold. The subsequent Acts of 1928 and 1931 introduced further changes and by the latter Act England went off the gold standard.

CHAPTER IV

Currency and Principles of Its Circulation

THE word currency refers to those articles which are the current media of exchange in a country and are commonly accepted in discharge of obligations. Some articles act as medium of exchange and pass on from hand to hand without reference to any characteristic except their passableness. People accept them in payment not because they know that they can have recourse to their issuer in the eventuality of their non-acceptance by others to whom they are offered in payment, but because they believe that others will accept them in payment just as they themselves have done. These articles constitute the currency. They include metallic money, both standard and token coins; convertible and inconvertible paper money and deposit certificates. But there are other articles also used in effecting exchanges which do not have a general circulation. They are acceptable more or less on a narrow area, and pass current primarily because of the credit of the issuer, and are not currency. Such articles are bills of exchange, hundis, cheques, promissory notes and other commercial paper and negotiable securities.

Thus the currency of a country is not simple, but very complicated and heterogeneous. We find in nearly all civilized countries coins of different metals and of different denominations circulating along with paper money and credit paper of private and public bodies.

The fundamental object of the currency organization of a country is to provide various kinds of circulating media to suit all kinds of transactions and payments required for such transactions. The currency organization must be flexible and automatically adjustable to the various needs of the people. Some people have to make large payments and others small. On the one hand payments run into thousands and millions of rupees and, on the other, the poor have small payments to make varying from a few annas to a few rupees. The currency system must be so organized as to meet all such needs. The currency requirements differ according to the stage of economic and industrial development reached by a country and according to the quantity of its national dividend. Where people are rich and *per capita* wealth is high as in Great Britain, large quantities of full legal tender money will be required; otherwise the public will feel great inconvenience in handling coins of a low denomination. A country like India with a smaller aggregate production and with a low *per capita* income

will require a larger quantity of token money. In India where banking facilities are meagre and consequently banking habit is little developed large quantities of metallic money will be needed ; but in England or America where people are used to credit instruments of all kinds, less of metallic money will be required for internal circulation. Thus the organization of currency will have to be different in different countries and its amount will be largely determined with particular reference to the needs and habits of the people. The best medium of exchange is one which provides instruments of exchange of different kinds and denominations to suit different scales of payment. The circulating medium of most countries includes metallic money, paper money and various credit instruments.

The metallic money includes standard or principal money which is usually gold or silver. The standard money is that in reference to which the values of all other commodities are determined. It may or may not be in circulation. In the United States of America the standard is the gold dollar which is nine-tenths fine, but which is not issued. The characteristics of standard money are: firstly, its bullion or real value is equal to its face or nominal value, but that may not be so in every country. In India, for instance, the rupee whose nominal or face value is greater than its intrinsic value is the standard money. Secondly, it is everywhere declared to be legal tender the offer of which is sufficient to discharge obligations. A legal tender law prevents uncertainty in contracts and saves weak creditors from being imposed upon with spurious money. It does not, however, compel people to discharge their obligations by other means of payment. They can discharge their obligations through cheques, bank drafts, etc., provided creditors are willing to accept them in settlement of their claims. Once accepted, they constitute a sufficient discharge of their obligations unless they are finally dishonoured on due presentment. Finally, no central institution is bound to redeem or convert the standard money into some other kind of money. Convertible paper is not standard money, because the issuer, the bank or the state is bound to convert it in gold or silver coin if the holder so likes.

Metallic money also includes subsidiary coins which are generally of a different metal from the standard one. They are sub-multiples of the standard money and are usually made of silver and copper. The smallest denominations are sometimes called minor coins. The subsidiary money is limited to payments of certain amounts. In the U.S.A., half and quarter dollars and dimes are legal tender only to the extent of ten dollars and the five cent piece and the copper cent serve as legal tender for twenty-five cents. In England silver is

legal tender for 40 shillings. Similarly in India, eight-anna, four-anna and two-anna bits are legal tender only to a limited extent, but the rupee is the legal tender for all amounts.

A subsidiary coin is usually though not always a token coin whose nominal value is greater than its real or intrinsic value. "Token coins may be defined in a preliminary manner as coins the nominal value of which as money is avowedly greater than their value as metal even if the cost of coinage is taken into account."¹ The object of token money is to afford convenience to people in making small payments and it provides economies in the use of precious metals. There is no free mint for token coins. The government retains the coinage of token money in its own hands and nobody can get silver or any other metal minted into token coins by the government. In England in the reign of James I the sole right of token coins was granted to a private individual with disastrous consequences so that later on the government had to take upon itself the duty of preparing such coins. The government also makes a considerable revenue by manufacturing these coins. The government in this respect incurs a serious responsibility because they will depreciate in value if issued in excess of the requirements of the people and an insufficient supply of them will cause a great inconvenience and loss to every one who wants change for the standard coin or currency notes. Token coins circulate at their face value because of the limitation of their supply to the money work they are expected to perform. Some people argue that token coins circulate at their face value because they are legal tender only to a limited extent; but this argument is altogether irrelevant. The rupee in our country circulates at its nominal value even though it is unlimited legal tender. The chief reason then for the circulation of the token coins at their face value is the limitation of their supply.

The fundamental cause for the circulation of money, whether it may be standard money or subsidiary money, is the belief of the receiver that others in turn will accept it from him in settlement of their claims. The area of circulation depends upon the nature of the confidence which induces acceptability and it may vary from a very small group to a very large one. It is this confidence which is the underlying cause of the acceptability of the various media of exchange.

The reasons for this confidence are four in number. One is the persistence of social habit which is the primary cause responsible for the circulation of commodity money. Commodity money like gold or silver is more widely circulated

¹ Nicholson, "*Money*", Part I, Chapter IV, p. 45.

than any other kind because its value arises from its use for purposes of art in addition to its use as money. This value continues so long as the demand for the commodity in question continues. People accept it in payment because they know that the desire for it is permanent and that in future also the public will accept it owing to force of social habit. But if a large and sudden supply of gold were to come through some new discovery or invention in its production or manufacture, its desire will suddenly fall and possibly it may not remain as valuable as it is now. It has value because it is in general demand and it is in demand because its supply is very small. People, therefore, have belief that its value will continue because they have been accustomed to it for long.

The second cause of this confidence is the authority of the government. We know that not only gold and silver which have an independent value for purposes of art, but paper money also which has value only by reason of its use as money, is in circulation. Its area of circulation is, of course, confined only to the political boundaries of a country. It circulates because people have faith in their government. They know that the government itself will receive it in taxes and will also redeem it in standard coin on presentation. In the next place, we find that promissory notes of private individuals and corporations also circulate though in a narrower area. It is because of the fact that the receiver believes that the issuer will redeem the article or pay legal tender money for it on presentation for payment on the due date of maturity. The cause of circulation here is commercial credit.

A fourth reason for this confidence may be the existence of an agreement among a certain group of individuals to accept the article in question in settlement of obligations. There is probably no historical illustration on the point, though some writers have traced the origin of money to the existence of such an agreement. If international bimetallism is ever brought into practice, we shall have a remote sort of analogy.

Each of these causes promotes the circulation of a different kind of money. So long as any one of them is present, the article for which a demand is caused will act as a medium of exchange. But as noted above, the primary cause of the circulation of any kind of money is the fact that the holder or the receiver believes that others in turn will accept it from him. Although an article may generally circulate as money owing to some reason or other, different portions of it may have different degrees of acceptability. This brings us to the consideration of what is commonly known as the Gresham's Law. The Law is incorrectly associated to the name of Sir Thomas Gresham, the founder of the Royal Exchange and Financial Advisor to Queen Elizabeth. It was known long

before Gresham's time although perhaps he was the first to formulate it scientifically.

Briefly stated the Law is that bad money drives good money out of circulation ; whilst good money cannot drive out bad money. It has three forms. Firstly, when in a country coins of the same metal but of differing weight and fineness circulate together at the same nominal value, the inferior coins have a tendency to drive the superior or the strong coins out of circulation. Coins are used for different purposes. They pass from hand to hand as current media of exchange. They are valuable as bullion also and if payments are to be made to foreign creditors, they will accept gold or silver bullion or coins also. It is clear that for such purposes full-weight coins will be more valuable than light-weight ones from the point of view of the debtors, who will get credit only to the extent of the bullion value of the coins. Naturally good coins will be exported in discharge of foreign obligations. Even if coins are to be melted for ornaments, the full-weight coins will be more valuable as bullion than light-weight coins. People also hoard coins to a greater or lesser extent in every country and new coins are preferred to old and clipped ones for this purpose also. For ordinary payments the inferior ones will be as good as the superior coins. Hence light-weight or inferior coins will remain in circulation and full-weight coins will either be exported or melted for arts or hoarded.

A second form of the Law is when coins of two different metals, say gold and silver, circulate side by side as full legal tender at a certain rate of exchange fixed by law. The market value of one metal in terms of the other may be different from the legally fixed value. In such a case the tendency will be for the coins with a smaller market value as bullion to drive out of circulation the coins with a higher value as bullion. An illustration from English history will make the point clear. In England in Edward I's reign gold coins constantly disappeared from circulation as soon as they were issued through being underrated. The legal ratio at which gold florins and silver shillings circulated was 1 : 6, *i.e.*, florins were proclaimed current at six silver shillings ; but in the market one florin was worth seven shillings. By melting a gold florin into bullion seven shillings could be realized while as florin, it could satisfy a debt of only six shillings. People, therefore, paid their debts in silver and hoarded, melted or exported gold.

A third form of the same principle is when inconvertible paper money circulates side by side with standard metallic money and both are declared as unlimited legal tender ; the full-value coins for the same reason will be driven out of circulation by paper money.

At first sight the statement that bad money drives good money out of circulation sounds paradoxical. Ordinarily people acting in self-interest prefer to keep what is good and reject what is bad. In case of money they seem to keep the bad and reject the good. This paradox is solved when we remember that the owner of money is a seller who sells the better goods because they can fetch him more in that way ; while he keeps the inferior money for purposes of payment. The object for which the bad money is used is to make payments and to effect exchanges and so long as this money is accepted by the creditor or the payee, the payer does not care more. It is in the best interests of the debtor to pay in the worst coins that he can obtain and pass them on in discharge of obligations.

This principle has two limitations. (a) At a certain time every country requires a certain quantity of money to meet the needs of her trade, commerce and industry. If the good and the bad coins together are only in such a quantity that they can barely meet such needs, they will circulate together. If the demand is not large enough to use all of them, the better coins will be withheld from circulation to the extent that the two together exceed the needs of the country. In other words, if the demand for them is so great that all of both kinds of coins will be required, the value of the inferior coins will rise to equality with the bullion value of the better or full-weight coins. It can never rise more than this, because the heavier coins will not be taken anywhere for more than their bullion value. But if the purchasing power of money will rise still further, foreign coins or bullion from outside will be imported and a rise in the value of the inferior coins above the bullion value of the full-weight coins cannot be expected.

(b) A second qualification is that the force of custom or habit may impede the operation of the Law. Coins pass from hand to hand by tail and ordinarily people accustomed to the use of a particular kind of coin go on using it even though it may have deteriorated in weight and fineness. This deterioration is not marked till it becomes appreciably great and every civilized government now makes arrangements for the withdrawal of bad coins within a certain period of time. Therefore till then generally the bad and the good coins circulate together. If the people of a country are bent upon not accepting the inferior coins, they cannot circulate against public opinion. The history of California during the American Civil War provides an apt illustration of the influence of custom as an obstacle in the operation of the Law. The government of the U.S.A. issued inconvertible paper money which circulated

in that country everywhere ; but the inhabitants of California did not use the Greenbacks issued by the government.

Gresham's Law is stated in a general form like this. " When a community in which competition is free and intelligent has a choice of means of payment, it will use the least expensive which will serve its purpose under existing circumstances. Or, in a community in which competition is free and intelligent there is a constant effort to perform every economic service by the agency which yields the largest net results."

CHAPTER V

Systems of Currency : The Gold Standard

CURRENCY systems may be broadly divided into two categories—metallic currency and paper currency. The circulation of metallic currency in a country depends upon the range of incomes and prices and the development of the art of coinage. In comparatively undeveloped societies coins are crudely fashioned and pass by weight and not by tale. The latter form could be possible only when the art of coinage was perfected. A single metal would serve as currency only in a community where people have got more or less uniform incomes and their tastes and fashions are also similar so that the amounts that they spend on different commodities are fairly uniform. In a modern civilized community based as it is on glaring inequalities of incomes from work and property both, one metal cannot serve as money. To suit different scales of incomes and prices, different metals will be used for purposes of coinage.

Jevons mentions five possible systems of metallic currency. One of them is *currency by weight*. According to the system the government provides weights and measures and people use them in weighing or measuring the metal used as money. This is the oldest method of making payments by means of metallic money. With the development in the art of coinage, this system has ceased to operate in modern civilized countries.

A second system is *unrestricted currency by tale*. According to this system the metal is made into pieces having uniform weight and fineness and they are stamped to indicate their value. On the strength of this certification, the coins pass as the current media of exchange.

A third is the *single legal tender system* under which only one commodity is coined into money and that is made unlimited legal tender for all amounts. The iron money of Sparta is an illustration on the point. But this system is suitable only in a very simple economic life where incomes and prices are more or less uniform.

A fourth one is the *multiple legal tender system* according to which coins are made of two metals, say, gold and silver and they circulate at legally fixed ratio and both are declared unlimited legal tender for all amounts. Bimetallism is an example of this system of currency.

Finally, there is the *composite legal tender system* according to which coins of only one metal are made legal tender for

all amounts and there are subsidiary coins which are declared legal tender for fixed amounts chiefly to suit people of smaller incomes. They are usually token coins and of a different metal. This is the system prevalent in all the advanced countries of the world to-day. Besides, cheques, bills of exchange, promissory notes and other commercial paper also serve as media of exchange. But they are not legal tender and their area of circulation is narrow though the volume of transactions settled through them is very considerable.

Every country has evolved a currency system particularly suitable to its economic conditions; but the fundamental principles underlying the currency systems of nearly all civilized countries are similar. The most important of these systems of currency to be considered in this book are : (1) The single metallic standard or monometallism. This means gold standard for all practical purposes because till recently the currencies of nearly all countries except those of China and India were on a full gold basis. (2) Bimetallism or the double standard which is nowhere in operation now. It shall be discussed because of its historical importance and also because there are some people who still believe in its efficacy. (3) Convertible paper money issued both by banks and governments. (4) Inconvertible paper money issued both by banks and governments. Now we shall consider these systems one by one in detail.

THE GOLD STANDARD

The gold standard was definitely adopted by Britain in 1816 and later on all the leading nations one by one adopted it. Under the gold standard all values are measured in terms of gold and coins of gold only function as standard money. According to the system gold alone performs the function of standard money. It serves as the measure of values, as a store of value and as a standard of deferred payments. Gold coins alone are declared full legal tender and thus capable of meeting all obligations and discharging all debts. It is not necessary that standard money alone should remain in circulation. Currency notes and subsidiary coins and cheques and other commercial paper also serve as media of exchange. Currency notes in practice, though convertible, are accepted generally in all amounts in satisfaction of debts and obligations. The currency of subsidiary money is necessary for discharging debts of small amounts; but the subsidiary coins are declared legal tender for fixed amounts only and they are not freely coined. If banking organization in a country is highly developed, actual metallic money may circulate to a small extent only and debts may be discharged through cheques in large amounts.

Another requisite of gold standard is that free mints are opened for gold only and the mint value and market value of

gold are the same. The weight and fineness of the coins are defined and anybody can take any amount of gold bullion and can get it coined gratuitously or at a very small charge.

A third requisite of gold standard is that paper currency of the country should be redeemable in gold coins without any restriction and without any limit as to amount.¹ This is necessary to give the desired elasticity to the currency. If people know that they can get gold coins in exchange for paper money on presentment, they are not likely to present large amounts of paper money for redemption and thus gold can be available for building reserves on the strength of which credit structure can be built.

It is clear that under the gold standard there is an automatic device for the expansion and contraction of currency. If there is any superfluity of coins, it can be removed by melting them. Owing to the fact that there is a free and open market for gold its outward and inward flow is unchecked. Foreign exchanges and the fluctuations in the rates of exchange between gold standard countries are confined only to the specie-points. They cannot go beyond them ; because then gold will begin to flow out or flow in as the case may be.

Payments in foreign trade are generally made through bills of exchange. This mechanism of payment in foreign trade through bills of exchange may be called the foreign exchanges. Let us suppose that an exporter in America has sold goods to an importer in England and that another person in England has sold goods to a certain person in America. In this case the American exporter has to receive money from the English importer and the English exporter from the American importer. Let us also suppose that both transactions are for £ 1,000. For simplicity we can suppose that the American exporter will sell his bill of exchange drawn upon the English importer, to the American importer who will send it to his English creditor. What amount will the American importer pay to the American exporter ? One thousand British sovereigns contain as much pure gold as 4,866 dollars. When a bill of exchange for £ 1,000 is sold for 4,866 dollars the exchange is at par or, in other words, exchange is said to be at par when the coin of one country exactly sells for its specie equivalent of another country. In the particular case exchange will be at par and the American importer will pay 4,866 dollars to the American exporter.

¹ Redeemability in gold coins did not remain the essential attribute of gold standard in the 20th century. Paper notes were generally made redeemable in gold bullion.

In actual practice exports and imports of a country to and from another country do not exactly balance. American exports to England may exceed her imports from that country. Americans will draw bills of exchange on their English debtors for a greater amount than the American importers will purchase. The exporters in America will offer more bills for sale than the importers require. Therefore exchange will not remain at par and the importers will offer less for the bills of exchange than their face value. But there will be a certain point below which the American exporters will not sell their bills of exchange. If the importers offer below that point, the exporters will send for sovereigns or gold bullion from England and get them converted into dollars in America. All this will mean some delay and expense. The total expense of sending specie from England to America is somewhere about one-half of one per cent. It comes to 21 dollars for every 4,866 dollars. The American exporter will not sell his bill of exchange of £1,000 for less than 4,845 dollars or 4.845 dollars per pound. If the importers offer less than this, it will be remunerative for the exporter to send for gold bullion. When foreign exchange is at this point specie begins to come in and this is called the specie-importing point from the point of view of America. Under these conditions exporters' bills will sell at a discount.

In the opposite circumstances, when the American exports to England may be less than her imports from the latter country, the importers will have to purchase more bills than the exporters will offer. Consequently, they will be prepared to pay 4,885 dollars for every bill of exchange of the face value of £1,000. The exchange will be 4.885 dollars to the pound or it will be above par and this is called the specie-exporting point. The importers will not pay more; for in the alternative the sending of specie will become more profitable. Thus between two gold-using countries the rate of exchange will be between these two specie-points. If it falls below the specie-importing point, gold will flow in and its value will fall in America. This will lead to a rise in prices and imports will be stimulated and the exchange rate will have a tendency to rise. Thus foreign exchanges under the gold standard adjust themselves automatically and the divergence is confined to the two specie-points.

These were the features of the gold standard which was prevailing in all countries except China and India before the war and which was restored in the post-war period with slight modifications. It was prevailing in England since 1717, though definitely adopted there in 1816. Originally, the English currency like that of other countries was on a silver basis and until the beginning of the 18th century the bulk of

her coinage was of silver, but gold also had been circulating at varying rates in relation to silver.

In 1663 the guinea was coined to circulate at 20 shillings. But the silver currency was in a depreciated state and the weight of the silver shilling was much below that which was fixed by law. Consequently, the value of the guinea in terms of shillings was rising very much and people did not part with guineas for less than thirty shillings per guinea. In 1696 silver was recoined at a cost of £ 2,700,000 and the price of guineas went down to 22 shillings; but as new coins of silver were brought into circulation, they rapidly disappeared. Gold being over-rated was driving silver out of circulation. It was because the price of the guinea was fixed at 22 shillings; while the market value of guineas in terms of shillings was less. Therefore silver was more valuable as bullion than as coin. Gold at this ratio was over-rated and silver went out of circulation.

In 1717 Sir Isaac Newton being asked to give his advice issued his report in which he pointed out that the ratio between gold and silver in other countries did not exceed 15 : 1 and according to this ratio, the guinea would command 20 shillings and $8\frac{1}{2}$ pence in silver. In England it was exchanged for 21 shillings and 6 pence. It was profitable for these countries to send gold to England and buy with it silver. He, therefore, recommended a reduction of 12d. from the value of the guinea in shillings; but this value was to be reduced gradually according to convenience and experience. He recommended an immediate reduction of 6d. so that the value of the guinea would be 21s. in silver and that would diminish the incentive to melt down silver coins. But this was to be the preliminary step only and further reduction was also to take place.

The government accepted the recommendation and fixed the legal ratio of the guinea at 21s., but carried out no further reduction even though that was necessary. From 1717 to 1816 gold and silver by custom were legal tender to any amount and there was free coinage of both at a fixed legal ratio. Thus virtually the characteristics were of a complete bimetallic system. But in actual practice, no one brought silver to the mint to get it coined, because its bullion worth was more than its money worth. It was more profitable for an Englishman to buy gold on the continent and produce it to the mint in England. In Europe the gold that was to be contained in a guinea could be purchased for 20 shillings and 8 pence only; whereas in England if a man took silver to the mint and received coin, it would take 21 silver shillings to purchase as much as a gold guinea at the ratio fixed at law.

Therefore the circulation of silver coins became less as they were melted and the difficulty increased to such an extent that

they were not available for exchange also. Those which remained were depreciated to a great extent and their bullion worth was much less than their face value. To prevent further clipping of the current silver coins it was enacted that for above £ 25, silver coins were to be legal tender by the worth of their bullion only at 5 shillings and 2 pence per ounce and not according to their face value. Gold in this way supplanted silver and people became accustomed to gold coins. When the coinage was re-organized in 1816, gold which in practice had become standard coin long since, was made so at law also. Silver coins became subsidiary coins and their face value was greater than the value of the bullion contained in them. Lest they should draw gold coins out of circulation, their coinage was undertaken by the government on its behalf and free mints were left open for gold only. Thus in 1816 England became a gold standard country.

Other countries followed England in this respect. America in 1873 adopted this standard though it was prevailing there virtually since 1850; the German Empire put her currency on a gold basis in 1871, and soon after, the Latin Union also adopted it as their system of currency.

CHAPTER VI

The Gold Standard—(*Contd.*)

CAUSES OF ITS ADOPTION

A MONETARY system is to be judged by the stability of its purchasing power in terms of commodities. It is very necessary for a good monetary system that its value as measured in terms of commodities or, in other words, its purchasing power should remain stable over long periods of time. The history of the evolution of money shows that throughout all ages in the selection of different commodities to serve as money at various times, society has selected those articles to perform the functions of money whose value has remained more steady over long periods than the value of other articles. As a better article was found from this point of view, it served as money. There are many articles which perform much better than gold and silver one single function of money ; but they have all been gradually discarded in favour of gold, because it is gold which performs all these functions together in a much better way than is done by any other precious metal. We live in a society based upon money economy. The progress of our society depends upon a good system of money and the vast superstructure of industrial system is closely inter-dependent upon money. Money augments the quantitative production of wealth to a great extent and makes possible the most complete satisfaction of human wants that is compatible with the present state of society. Division of labour increases more and more and consequently production is becoming more and more round-about and indirect. It is not simple and self-centred, but highly complex and round-about.

The entire commercial and industrial organization of our society rests on a contractual basis. In primitive times men cared little for the morrow and lived only in the present. With increase in civilization and with progress in science, man has risen above his animal environments and for the fulfilment of his aspirations he has been able to link the present with the past and a successful future in the light of the past experience. The economic organization of our civilized society rests on credit. People enter into contracts in the present which are to be fulfilled in the future. Hundreds and thousands of contracts are entered into for future performance. Some of them are to be fulfilled in short periods and others in long ones. The latter involve the lapse of years between the day they are made and the day they are to be performed. This

happens when delivery of articles of iron and steel goods like locomotives, machinery, plant, etc., is promised to be given at some future time.

It is very natural for the parties entering into contracts to perform them at some future time to expect that the purchasing power of the monetary unit in which they are to discharge their future obligations should remain stable in the meantime. A man, of course, knows when he enters into a future contract that he is taking risk of alteration in the value of money in terms of commodities. But all the same, violent and long-continued disturbances in the purchasing power of money make things very uncertain, create maladjustment and bring in their train all the concomitant phenomena of trade depression, financial crisis and unemployment. It is for this reason that demand for comparative stability in the purchasing power of money is an organic demand of the industrial life of to-day and it is why a commodity like gold has been selected as money. This is the underlying motive of all financial proposals that have been brought forward and discussed in the press and in the legislative chambers among statesmen, financial experts and politicians after the war.

Credit expansion has taken place enormously under money economy. It is on the strength of the reserves of metallic money that the vast superstructure of credit can be built with great convenience and benefit to the public. The raising of credit plays a very prominent part in the economic organization of our society. Confidence among the public is the most important requisite for the proper maintenance of a good credit system. This confidence can only be created if people believe that the credit instruments will be redeemed when presented for payment to their issuer. A proper expansion of the currency system is possible only with the help of metallic money. It is only the metallic money which can inspire confidence in the relative purchasing power.

The growth of capital comes from savings and depends upon the power and the will to save. The will to save is considerably affected by the expectations of people about the purchasing power of money at future time. If people expect that the purchasing power of their savings in the future will not remain as much as at present, savings will considerably diminish. Saving is the result of waiting to enjoy a certain amount of wealth in the future rather than at present. Everybody can if he so likes spend all his income on present pleasures rather than on future ones. Rightly or wrongly an ordinary individual prefers present pleasures to future ones if he is given the choice to spend all his income now or at some future time. It is a psychological fact of great importance that present pleasures are given greater weight than future ones.

even though the latter may be as sure as the former. As such, people will not save much if they think the value of money will fall ; because then their savings will be worth less in terms of commodities than they will be if the purchasing power of money changes but little. People save because they are confident that the value of money will remain relatively stable and because they are sure that the Government will allow them to have the use of their savings in the way they like. Thus to encourage savings it is necessary that the purchasing power of money should remain fairly stable. The uncertainty in the purchasing power of money would sap the very foundations of our economic society ; it would disturb the relations between debtors and creditors and by disturbing the existing distribution of wealth would make co-operative production on a large scale impossible.

The desire for relative stability in the purchasing power of money really explains the history of the evolution of monetary systems. That commodity whose value remains fairly stable has been selected to serve the functions of money. Up to the middle of the 19th century gold and silver were the commodities whose value was fairly stable. Therefore both of them were selected to fulfil the functions of money. Double standard was prevailing in nearly all countries up to the middle of the 19th century except in England. Even prior to that, silver was more important from this point of view and, therefore, it served as standard money in the early Middle Ages. Gradually, gold began to gain popularity with people and began to be desired like silver. Its value, therefore, gained stability and side by side with silver it served as money up to the middle of the last century. Relative stability in the purchasing power of the monetary unit was secured by the joint or alternative use of gold and silver because both commodities were suitable for this purpose owing to their lustre and sheen, durability and attractiveness. By the end of the 19th century all civilized nations of the world discarded silver in favour of gold, China being the only country whose standard money consisted of silver. Let us recapitulate the reasons why gold standard became the system of monetary unit of all nations by the end of the last century. The causes were more or less the same owing to which formerly other commodities had been discarded in favour of silver. One of the most important reasons for this change was a very great increase in the production of silver in the 19th century. This shook the confidence of the civilized world in the relative stability of its purchasing power. Violent fluctuations took place in the gold price of silver during the period owing to its enormous production. The production of silver had been increasing since the second quarter of the 19th century. The annual supply of silver prior to 1870 had

been 30,000,000 ounces annually. The figures for the period after 1870 rose thus :—

| Average annual product in the five year period | | Million Ounces |
|---|----|----------------|
| 1871-1875 | .. | 63 |
| 1876-1880 | .. | 79 |
| 1881-1885 | .. | 92 |
| 1886-1890 | .. | 109 |
| 1891-1895 | .. | 158 |
| 1896-1900 | .. | 165 |
| 1901-1905 | .. | 168 |

It must be borne in mind that by 1893 the U.S.A. and India, the last two markets for silver, were closed. So great a supply from the mines specially when most of the mints were closed to the free coinage of silver caused a decline in its price. After 1906 the rate at which the annual supply of silver was produced rose still further. Owing to this continued fall in the value of silver in terms of gold all countries one by one gave up the double standard in favour of the gold standard.

Another reason for the adoption of the gold standard was that industrial and commercial expansion of the Western nations during the 19th century was very great and rapid. With an increase in production, demand for labour, capital and urban sites grew very much and this led to increase in wages, rents and prices. A prosperous nation requires a currency that carries high value in small bulk. Therefore, the prosperous nations of the West selected gold as their monetary unit because it enabled large values to be carried in small bulk.

In the last quarter of the 19th century, there had been a great improvement in the means of communications. The various parts of the world were connected with one another by means of railways and steamships. Difficulties of distance which had formerly been regarded as insuperable were overcome to a great extent. The various parts formed one single market for important commodities. This interdependence of various countries of the world in commercial and industrial matters required a sort of common medium of exchange which at the same time could carry large values in small bulk. Gold was the commodity which satisfied this condition and hence the gold standard was adopted.

A monetary system that develops commerce, stimulates industrial expansion and fosters material welfare can achieve these advantages and benefits only inasmuch as it secures relative stability in its purchasing power. A standard of value whose purchasing power is relatively steady also secures impartial treatment between the different sections of society. It has been realized that gold is the one commodity that fulfills

these functions better than others. It is by no means true that the value of gold in terms of commodities has remained or is likely to remain perfectly stable from time to time. In fact there were violent fluctuations during the war. Even before the outbreak of the war its value had varied greatly from time to time. During the 20 years before 1809 gold prices had doubled and the situation was reversed in the latter decades. Between 1873 and 1896 its value in terms of commodities rose by about one-quarter and from 1896 to 1914 it fell by about one-third. In spite of these fluctuations gold was the one commodity whose value as compared with the values of other precious metals remained fairly stable. This was found by a long process of trial and errors that among the available commodities gold was the best from the point of view of performing the functions of money.

The value of gold fluctuated to a less degree than the value of silver. The purchasing power of gold in terms of other commodities remained relatively stable on account of two causes. Firstly, the stock of gold existing in the world is very large and secondly, its annual production as compared with its stock in existence is very small. Therefore, fresh supplies cause very little variations in its value.

The progress in the production of gold kept pace with the progress in other directions. As has been pointed out industries and commerce expanded very much in the last century. Consequently, vast amounts of capital were required to develop natural resources to maintain and accelerate the pace of production. Capital came from savings and from progress in the methods and arts of production. For all these reasons money was required in increasing quantities, and fresh supplies of gold to a great extent served as reserves on the strength of which credit could be developed and currency could be expanded.

A steady influence on the value of gold was exerted by its absorption into the arts and into the hoards of Asia. The Eastern countries have for long been consuming vast quantities of precious metals in the arts. In the absence of proper banking facilities savings in these countries mostly have been in the form of hoards. It is the precious metals which can retain their value even when they are hoarded. Increasing supplies of gold found their way into the hoards and into the arts of Asia. Consequently, the total annual supply of gold, being very small as compared with its total quantity in existence and being consumed for the purposes of arts and into the hoards of Asiatic countries, caused very little changes in its purchasing power.

The world has not yet been able to find a commodity whose value is absolutely unchangeable. It is beyond human power

to conceive of a commodity that does not undergo any change whatsoever in its purchasing power. In fact prices can never remain fixed owing to dynamic forces. There are always changes in every aspect of life. Nothing in this changing world of ours is permanent and if anything is permanent it is change. Change is incessantly going on. Population increases, customs change and habits and fashions never remain the same. Therefore, there are changes in prices also and this means that there are changes going on in the values of all commodities. Of all such commodities gold has proved itself to be the fittest commodity to serve as money in the economic organization of the society in which we are living. Gold standard has proved its soundness more than any other standard. It may not be a perfect standard ; but the mere fact that it has been chosen by the most advanced nations of the world is a very strong proof of its being the best commodity to serve as the standard of value. The gold standard has not been imposed arbitrarily but has come automatically.

It is true that in nearly all countries except in America the gold standard broke down during the war. There were very violent fluctuations in its value in terms of other commodities. After the war the financiers and statesmen in various countries were busy in putting their currency systems in order. The gold standard with slight modifications was restored in all countries.¹

¹ The standard has now ceased to function over three-fourths of the globe and there have been very violent changes in gold prices. See Chapter XI.

CHAPTER VII

Bimetallism

It has been explained in the foregoing chapters that stability in the value of money is a necessary condition for the growth of business. The attainment of stability in the value of money has been attempted in two ways. One of them is the gold standard or the monometallic system which was till recently prevailing in nearly all the important countries of the world. The advocates of the gold standard with England at their head do not deny the changes which have taken place in the value of gold ; but none-the-less they hold that monometallism of the gold standard has best stood the test of experience.

A second means of gaining stability in the value of money has been the multiple legal tender system or bimetallism. The advocates of this system under the leadership of France claim that under certain circumstances the double standard or the union of gold and silver as a joint standard of value would prove more stable than the gold standard has been ; but they hold that the system has not had a fair trial.

The question of the standard of value was once a very controversial one. This controversy with regard to the adoption of bimetallism ceased with the advent of the present century and now it has only a historical or academic significance. To understand monetary problems more clearly, we shall discuss bimetallism.

Under the bimetallic system gold and silver are freely coined. Any person can bring silver bullion to the mint and have it manufactured into coins to any extent. The cost of manufacturing coins may be borne by the Government or by the holder of the bullion. The same right is given to the holder of gold bullion. All coins—gold or silver—are made full legal tender for discharging obligations. The debtors have the option to meet their obligations either in gold or in silver coins or both. It is also necessary that coins of the two metals should circulate at a ratio fixed by the State. But it is conceivable that as regards coinage and legal tender the Government may put gold and silver on precisely the same footing and yet at the same time allow the ratio of one metal to the other to vary according to the market price of the two metals or according to proclamation from time to time. This would give rise to great inconvenience if the relative values of gold and silver coins were changing constantly and would

make the poor and the ignorant liable to frauds. Therefore nations which adopted bimetallism practically always issued their coins at a fixed ratio. Thus these three elements—free coinage, full legal tender and a fixed ratio—are the essentials of the complete double standard.

The real difficulty under a complete double standard arises with regard to the fact whether the legal ratio fixed by the State would conform to their values as bullion in the market. If the ratio fixed at the mint is $16 : 1$, i.e., the law says that 16 ounces of silver will be coined into as many sovereigns as one ounce of gold and if as bullion $15\frac{1}{2}$ or 15 ounces of silver are sold in the market for one ounce of gold, no one will bring silver to the mint. Silver under such circumstances is more valuable as bullion than as coin. Therefore, it will not circulate as money. A holder of silver bullion will get at the mint as many sovereigns for 16 ounces of silver as he can get for one ounce of gold; but in the market he can purchase more than one ounce of gold for 16 ounces of silver when the market price is $15\frac{1}{2}$ or 15. Gold can be presented to the mint and more sovereigns can be obtained than can be obtained by presenting silver to the mint directly. Under such circumstances the coins will consist of gold alone. This will cause inconvenience for silver coinage may not be available for small purchases. On the other hand, if the market ratio alters to such an extent that 17 ounces of silver in the market will fetch one ounce of gold, nobody will present gold to the mint, because in this case gold will be more valuable as bullion and hence will be exported or melted down to be used in the arts.

The metal which is presented to the mint under such conditions is said to be overvalued and that which is melted down or exported because of its being more valuable as bullion is said to be undervalued. When the mint ratio is $16 : 1$ it means that as many sovereigns can be coined for 16 ounces of silver as for one ounce of gold. In the market only 15 ounces of silver may purchase as much as one ounce of gold. In such a case silver is more valuable as bullion and is undervalued at the mint. But if in the market 17 ounces of silver purchase only one ounce of gold, the mint ratio remaining the same, silver is overvalued at the mint; because according to the mint 16 ounces of silver are equal to one ounce of gold; whereas in the market 17 ounces are equal to one ounce of gold.

That metal which is overvalued will have a tendency to drive out the undervalued metal from circulation. It alone will be presented at the mint for coinage. Its withdrawal from the bullion market will tend to raise its value there. On the other hand, the undervalued metal not being presented

at the mint for coinage will increase in supply in the market and this will tend to lower down its value. In this way the market ratio will always revert to the legal ratio whenever any divergence between the two takes place. This steady-ing influence of the effer of free coinage under the double standard upon the relative value of gold and silver has been called *the compensatory action of the double standard*. It is main-tained that as one metal was thrown upon and the other with-drawn from the bullion market, the former would fall and the latter would rise in value and thus the ratio would be restored. Those who rely upon this compensatory action of the double standard maintain that the ratio could never remain disturbed for long. It would be restored very soon after disturbance.

This compensatory action is, however, possible only in certain circumstances and for some time. If there be a permanent force bringing about this difference the ratio will not be restored. The undervalued metal will gradually go out of circulation and the metallic money will consist of the overvalued metal only. If the variation between the mint and the market values is considerable and remains for long, the metal which is cheaper in the market will displace the other in a very short time.

These principles are supported by the history of bimetal-lism in France, the U.S.A. and other countries. They led to the adoption of the gold standard and to the degradation of silver to the position of a subsidiary coin with mints closed to its free coinage.

France reorganized her currency system in 1803 and adopted the system of bimetallism at the ratio of 15 : 1. It became very difficult to keep this mint ratio identical with the market ratio of the two metals as bullion. The market ratio differed from time to time from the mint ratio and sometimes gold and at other times silver began to be overvalued. The undervalued metal was driven from circulation and the double standard became in actual practice an alternating standard. At one time the bulk of coinage consisted of silver and at another, of gold and the two together remained in circula-tion in large quantities only for very short periods.

Up to 1850 the bulk of the coinage of the country consisted of silver because the market ratio was slightly above 15½ : 1. Silver became the cheaper of the two metals and, therefore, displaced the dearer metal, gold, from circulation almost entirely. In later years the situation was changed owing to the gold discoveries in the middle of the 19th century. The Californian and Australian gold fields were opened in 1848 and 1857 respectively. Conditions of mining were easy and cheap and gold production increased enormously. The annual

production of gold between 1831 and 1840 was £2,830,000 ; this average rose to £7,638,000 for the next decade and to £27,815,000 between 1851 and 1860. Gold became the cheaper metal and the market ratio between gold and silver fell below $15\frac{1}{2} : 1$. Gold and not silver was presented at the mint and the latter being more valuable as bullion was withdrawn from circulation. Prices also rose during this period in France.

In 1865 the Latin Union was formed consisting of France, Belgium, Italy and Switzerland to prevent the disappearance of silver coins from circulation. In 1868 Greece also joined the union. According to the agreement of 1865 gold coins and the five Franc silver coins were to be freely coined, to be of the same weight and unlimited legal tender in these countries. The smaller silver coins became subsidiary coins and were made legal tender to the extent of fifty Francs only in the country where they were coined. Very soon after the signing of the agreement by the Latin Union, the course of events took a different turn. The production of gold by 1860 had reached its maximum and then barely held its own. The new supplies no doubt were as great as before 1860 ; but as the nations were becoming richer and industries were expanding greatly, these supplies did not keep pace with the demand for gold. On the other hand, the production of silver increased very much. Great discoveries of silver were made in the U.S.A. and the price of silver fell in the market. For some years the market price was equal to the ratio of $15\frac{1}{2} : 1$. In 1873 it fell very sharply and became $16 : 1$. Gold began to flow out of France and silver began to flow in. This proved unwelcome to people who rightly or wrongly had become prejudiced in favour of gold. The main cause of this preference was the practice of England, the leading industrial country. Germany after 1871 definitely and finally adopted the gold standard following the lead of England. After 1850 the coinage of the U.S.A. also had been practically on a gold basis. Thus demand for silver for coinage decreased while the supply increased much. The problem was how to prevent the disappearance of gold coins.

In 1874 the Latin Union held a meeting at which it was decided to close the mints to the free coinage of five Franc silver pieces. Henceforward they were to be coined on government account and their issue was limited to the needs of the people. The five Franc pieces, however, remained full legal tender. The features of the currency system of France and of that of the Latin Union after 1874 were : (1) gold and silver coins continued to circulate side by side at the ratio of $15\frac{1}{2} : 1$ and both were unlimited legal tender and silver pieces were not subsidiary coins ; (2) the silver pieces were not freely coined and their bullion value was different from

their value as coins. Gold was the only freely-coined metal. This system is called the *limping standard* because it is neither complete double standard nor full single standard. It is something midway between the two.

In the U.S.A. an exactly similar situation was brought about through half measures and compromises. America had adopted the double standard in 1792 at the ratio of 15 : 1. Though this was very carefully chosen, yet it began to differ from the market ratio which was $15\frac{1}{2} : 1$. At the latter ratio, silver was overvalued and, therefore, it drew gold out of circulation. This situation continued till 1834 when the mint ratio was changed to 16 : 1. This became above the market ratio of $15\frac{1}{2} : 1$ and gold was overvalued then and began to draw silver out of circulation. Gold discoveries took place in California in 1850 and the change became very pronounced. In 1873 free coinage of silver dollars was stopped though they remained full legal tender. In this year bimetallism which was long obsolete in practice was formally ended by law. This was another cause of the decline in the price of silver. This alarmed the silver producers in America who succeeded in passing in 1878 the Bland-Allison Act according to which the government was to purchase every month from 2,000,000 to 4,000,000 ounces of silver and to coin it in silver dollars which were legal tender. This measure was enacted to prevent a fall in the value of silver. Nobody demanded these dollars for people were used to paper money. These dollars remained in the Treasury and their place was taken by the paper money which was convertible into silver currency if anybody wanted it. This measure failed to achieve the object for which it was enacted and, therefore, in 1890 it was replaced by the Sherman Act according to which the monthly purchases were raised to $4\frac{1}{2}$ million ounces. The price, however, went on falling and in 1893 the Act was repealed. Under these two Acts the total number of dollars coined was 570,000,000. These dollars were like the French five Franc pieces, overvalued, limited in quantity and full legal tender.

In the meantime the problem was becoming specially pressing in India as our coinage consisted entirely of silver currency. Inside India the existence of free mints for silver coinage and a vast population demanding silver both for coinage and industrial purposes were the causes which maintained silver artificially at a high price. The value of the rupee at the original price of silver which was 62d. per ounce was 2 shillings. Its exchange value outside India was falling fast till in 1893 at the price of 35d. per ounce of silver, the rupee became worth only 1s. 2d.

This had a great effect upon the financial position of the Government of India. The revenue was raised in India in rupees,

but Home Charges had to be paid in gold. The rupees were not acceptable outside India at their face value, but at their bullion value. Consequently, the Indian Government had to pay more than the face value of the rupees. This demand was met by taxation. The import trade of India suffered because every importer had to pay more for his goods than the face value of the rupees as their value had depreciated much. But the depreciation of the rupee served like a bounty on the export trade. The exporter sold his goods in England for gold and when he converted the gold into rupees he got more rupees than were necessary to meet his expenses of production including ordinary profits. This made trade conditions very speculative and risky.

The Government in response to the recommendations of the Herschell Committee closed her mints to the free coinage of silver, for that was the only way to maintain the value of the rupee. The stoppage of the silver coinage was followed by an appreciation of the rupee and by 1898 it had reached the value of 1s. 4d. which was maintained up to 1914. This measure decreased the demand for silver to a great extent and brought about a great fall in the value of silver. Those who had hoarded their savings in rupees in India and also those who had large valuable ornaments of silver suffered much by this fall in the value of silver.

Thus by 1893 the mints of all the important countries had been closed to silver the supply of which was increasing. The world drifted rapidly to monometallism. The price of silver after 1873 was falling much and there was a fall in prices all round. The bimetallists pointed out that the supplies of gold were declining whereas the demand for money was increasing owing to an expansion in trade, commerce and industry. They said that for these two reasons gold had appreciated in value and that this appreciation showed itself in a fall in prices and silver having become a commodity showed that fall. According to them the remedy lay in making silver as the standard of value side by side with gold with free mints and the quality of full legal tender for both metals. For then the supply of money would increase and prices would rise again.

The gold monometallists did not accept the premises upon which the bimetallists based their arguments. They pointed out that the year 1873 and its immediate predecessors were years of abnormally high prices and, therefore, reaction in the form of lower prices was bound to follow as a natural consequence. Temporary ups and downs in prices though undesirable were also unfortunately unavoidable and time alone would provide the remedy. The advocates of the single standard said that silver could not rise in price to its original level. The demand for it could be increased by opening

mints for its coinage ; but that would increase its supply greatly for the smallest rise in price was bound to stimulate production. They also regarded silver as too cumbersome a medium of exchange for large payments and discouraged any attempts to open mints for its free coinage.

Attempts were made to revive bimetallism by international agreements ; but England always opposed any attempt at reviving bimetallism for that country had made great progress and occupied the central position as the money market of the world. She did not want to dissipate her energies in an experiment which had already failed in France and elsewhere. The question of bimetallism was for long the most prominent economic problem before the world, but after 1890 all interest in the matter disappeared suddenly. There were two reasons for this. Firstly, prices which had been falling since 1873 became stationary about 1895-97 and then took an upward trend. Secondly, the world's annual output of gold was increasing at a rapid rate. The insufficiency of the supply of money and the falling prices were two important arguments of the bimetallists to revive the double standard. With a rise in prices and an increase in the supply of gold, the two chief arguments of the bimetallists were annulled.

In one way the result proved the logic of the arguments of the bimetallists. The extreme wing of the monometallists had denied that the increased use of gold had resulted in a scarcity of that metal ; but the rise in prices following the increase in gold supply confirmed the arguments of the bimetallists.

Bimetallism as a system of currency was discarded in favour of gold monometallism in all countries of the world in the last quarter of the 19th century. For some time the bimetallists raised controversy to bring back their system into practice. International conferences were held to consider the possibility of a return to double standard and the bimetallists claimed that their system was theoretically sound and workable in practice. But England always barred the way for the re-adoption of the double standard. She was not prepared to launch on a scheme which had already failed in France and which was still more or less of the nature of an experiment. The gold standard was firmly established in England and the country had become industrially advanced and the practical minded English people were in no way prepared to reconsider the question of the standard. Without England no other important country was prepared to enter into an agreement for the readoption of bimetallism. But gradually events took place which cut the ground from under the feet of the bimetallists and the question was dropped by 1890.

Let us consider the advantages claimed by the bimetallists for their system. They point out that stability of prices is greatly attainable under bimetallism. The changes in the purchasing power of money cause a great disturbance in all manner of ways. No one will deny that the more steady the range of prices, the better it is for the whole community. Comparative stability in the value of money is very desirable. The bimetallists hold that the gold standard has proved inadequate in maintaining the stability of prices. They refer to the severe depression caused by a violently downward movement of prices after 1872-73, when silver had been reduced to the position of a token coin and the standard coin consisted of gold only the supply of which was not keeping pace with its demand for monetary purposes. Its demand was increasing on account of the expansion of trade and commerce and owing to the increase in the efficiency of capital and labour the amount of business to be done was increasing. The value of money rose and prices fell as a consequence. Some people pointed out that falling prices were due to inventions and improvements only and not to the contraction of currency ; but the bimetallists contended that this view was wrong because if the depression was caused by over-production, it would have been over after a short time. Prices in fact rose as a result of the increase in the volume of currency in the last decade of the 19th century. This increase in the currency was made possible by the increase in gold production. This proved the point of the bimetallists that prices after 1872 had been falling owing to the contraction of the currency. The fall in prices had an adverse effect upon profits, rents and wages, because all these incomes depend upon prices. The bimetallists had suggested the adoption of the double standard as the only remedy to prevent depression, for the deficiency in the supply of currency caused by the low supply of gold could be compensated by the increasing supply of silver.

The opponents argued that the prices of 1872-73 were extraordinarily high and that no return to this old level was possible and that all arguments based upon them were irrelevant and that a fall in prices was the natural reaction. Moreover, they contended that wages had not fallen as much as prices and that the fall in prices was favourable to labour. Therefore they welcomed a still further fall in prices in the interests of labour. This, however, was a wrong view, because a fall in prices being permanent could not be in the interest of any class. Wages and profits fall together or rise together. A fall in profits would contract business and in course of time would actuate business-men to withdraw their capital from business and this would cause unemployment for labour. Naturally a permanent and long-continued fall in prices could

not be beneficial even to the labourers. Hence the bimetallists had advocated a return to the double standard.

In the next place, it is claimed for bimetallism that the system would keep steady the par of exchange between countries trading with one another. The uncertainty and inconvenience arising from fluctuations in the rates of exchange between gold and silver using countries are very great. They upset foreign trade because a very small rise or fall in the rate of exchange is sufficient to turn the expected profit into a loss and *vice versa*. It is a well-known fact that a depreciated currency favours exports and acts as a check on imports. Let us take the illustration of England and India, the one a gold using country and the other a country using silver for its internal currency. The depreciation of silver in terms of gold will not raise prices in India. Its only effect will be that people in our country will have to pay more for ornaments of gold than they used to pay formerly. If India has to export articles, she will sell them in England in gold and will convert the gold into silver. Obviously if prices of the Indian products remain at the same level in England, that will mean that Indians after converting the same amount of gold into silver will get more rupees—silver having fallen in terms of gold. On the other hand, if the rupee price of English goods in India is the same as before, that will mean that less gold will be obtained than formerly for the same quantity of goods. Unless cost of production declines in England for Indian imports from the former country, this state of affairs is bound to decrease imports into India from England. Exports for a similar reason from India to England will be stimulated, for Indians will get more silver for the same amount of gold. Hence this will encourage exports from India to England.

It may be supposed that owing to the depreciation of silver in terms of gold, silver may fall in price in England without any response being made by prices in India. That may mean that with a fall in the value of silver in England, less gold will be obtained, and that will give the same number of rupees to the Indian exporter as he used to get formerly. Consequently, he will get his usual profits. This effect is similar to a bounty on Indian exports. A bounty increases the quantity of goods exported, lessens their price in the foreign country and puts the foreigner at a disadvantage. The fluctuations in the rate of exchange between gold and silver using countries by creating uncertainty upset foreign trade. The bimetallists claim that their system would remedy this disadvantage.

A third advantage claimed for bimetallism is that it would remove injustice arising from changes in prices to various members of the community. Rising prices are advantageous to debtors and to the business community; while they are

disadvantageous to creditors, labour and those having fixed incomes. Falling prices are advantageous to those having fixed incomes and to the creditors and disadvantageous to the other classes. The bimetallists claim that their system would remove this injustice of changing prices by making prices more steady. But it is an admitted fact that it would not completely eliminate changes in prices. As such, it is difficult to see how it would prevent injustice to various classes. It could do so only if the former prevailing level of prices could be reached, but that would be unattainable. Hence this advantage seems to be more apparent than real.

We shall now consider some of the main objections to the double standard. Firstly, it is urged that the introduction of the system would imply interference with the vast majority of contracts. The debtors will have the option of paying in silver rather than in gold and this will be prejudicial to the interests of the creditors. In fine, the real charge against the standard is that those who had contracted to pay in gold would be allowed to pay in silver. The issue can be cleared up by saying that a majority of transactions are settled in money and not in bullion. The contracts are not to be fulfilled by the actual transfer of gold in the case of civilized nations. So long as the ratio remains constant, silver would serve this purpose equally well. The banks will readjust their reserves of gold or silver as the case may be to suit the convenience of their customers. At present in some countries a creditor can be compelled to accept a currency note issued by Government or by a Central Bank. Silver coins can also serve this purpose equally well. If now no injustice is done to the creditors still less would it be done if payments were made in silver.¹

In the next place, it is urged that the immediate consequences of the adoption of bimetallism would be very unsatisfactory. The rate of exchange will change owing to an increase in the demand for silver for monetary uses and this will create an element of uncertainty in trade with silver-using countries. But it must be urged in answer to this that such an inconvenience in foreign trade will be temporary only and everything will become very smooth when things are properly adjusted in course of time.

In the third place, it is urged that great disturbances will be caused with regard to trade with silver-using countries. As has been already pointed out a depreciation of silver acts as a bounty on exports from silver-using countries and a check

¹ As a matter of fact America has now agreed to accept the payment of her debts from her European debtors in silver after the country recently went off the gold standard.

on or protection against imports into the silver-using countries. This check on imports gives some advantage to the silver-using countries, for they get a chance to improve their nascent manufacturing industries. The adoption of bimetallism by checking the fall in the value of silver will cause disturbances in trade in the silver-using countries. This will encourage imports into and discourage exports from the silver-using countries. If gold becomes less valuable, and that is what will be done by bimetallism, the gold-using countries will get a greater number of gold coins in exchange for silver coins from trade with the silver-using countries and provided prices in gold-using countries remain as before, this will encourage their exports to the former countries. It may be said in answer to this objection that when some countries use gold and others silver as their currency, the depreciation of silver gives a sort of artificial stimulus to the trade of the silver-using countries and that bimetallism would make conditions more certain and more steady. For some time the silver-using countries may lose, but this monetary loss would be subject to compensation. Capital would flow from the gold-using countries to the silver-using countries to develop their resources.

Another objection urged against the system is that it would cause an inflation of prices by increasing the currency in circulation. This would lead to speculative mania and in the long run might cause crises. It is also said that this inflation of prices would be disadvantageous to the creditors. This is the reason on which the supposed interference with contracts is based. It is true that an undue increase in currency not warranted by an increase in business will bring about this result. But it is also true that prices in the past fell in some years owing to contraction of currency. In the Middle Ages trade and commerce were very much hampered by the lack of currency. The silver discoveries later on provided a great stimulus to business by increasing the quantity of money. With improvement in the credit system in modern times this difficulty is avoided to a great extent. The increase in trade, commerce and industry in modern times requires the increasing use of money. The fall in prices after 1872 was the result of lack of sufficient money to meet the growing demand of businesses. It may be said that the increase in the production of gold and silver will be absorbed, because money will also be required in increasing quantities for the arts owing to an increase in the wealth of people.

Finally, it is urged that the difficulty of maintaining the market ratio of gold and silver identical with the mint ratio would make bimetallism impossible in practice. The bimetallicists on the other hand rely on the compensatory action of the double standard to maintain the ratios identical. They

refer to the French experience after 1850 when the divergence between the market ratio and the mint ratio was negligible, and automatically the two came together after a slight variation. But this process had proved very expensive to France.

The bimetallists point out that the adoption of their system by all the civilized countries would maintain the market and mint ratios identical. For if the ratio fell, where would the dearer metal go? It is held that the withdrawal of the cheaper metal from the market would raise its value by decreasing its supply there and the increase in the supply of the dearer metal in the market would bring down its price there. Thus the ratios would be restored. In fact those who rely upon the compensatory action of the double standard hold that the ratio could never be disturbed. But national pride, the changes that would be caused in the currencies of the countries by the adoption of the double standard and prejudices of various sorts stand in the way of international bimetallism.

In the last decade of the 19th century many international conferences were held to revive bimetallism; but a rise in prices because of increased supply of gold put an end to this demand for bimetallism. The question has now only an academic and a historical importance.

CHAPTER VIII

Paper Money

IT is not in modern times only that the use of paper as medium of exchange has been evolved. There is evidence to show that paper money was used in China as early as the 9th century and people in Ancient Assyria and Babylon were well acquainted with paper money. It was in the latter part of the 17th century that paper money was used on a considerable scale. The public and semi-public banks began issuing promises to pay which began to pass into circulation because of being convertible into specie.

Historically the origin of money does not lie in compulsion or even in deliberate selection, but it lies in the customary acceptance of some commodity of general serviceableness. When such a commodity habitually comes to be generally accepted without demur or delay in satisfaction of debts and obligations, the State can very much affect its value and the mode of its circulation. The advantages of the use of paper money were gradually realized and the public and semi-public bodies began to issue paper so that by the 18th century its use became very familiar and the way was prepared even for the issue of paper which was not ultimately to be converted into metallic money.

Paper money is of three kinds : (1) *Representative paper money*—is that for which specie of equal face value is kept in the bank or currency office to be given over to the bearer of paper money on demand in exchange for the paper note. (2) *Convertible paper money*—consists of notes issued by an individual or a public or private concern promising to convert them in metallic coin on presentment. It is not directly backed up by specie but by the faith which the issuer or the promiser can inspire. Payment should not be in anything except legal tender money ; otherwise it cannot be called convertible paper money. The notes should be as a matter of fact payable in specie on demand. The word convertible applies only to redeemability in legal tender or standard money in monetary science. It is because what businessmen need in exchange for paper notes can be of service to them when and where paper money will not be accepted. The only suitable money under such circumstances is the standard metallic money. No other commodity can serve this purpose. (3) *Irredeemable or inconveritible paper money*—consists of paper notes for which specie is not obtainable on demand. It may be that at a time paper money may have been issued with the intention of

redeeming it, but later on it may have lost its convertibility on account of the insolvency of the government or the issuing bank. It may also be issued without any intention of converting it into specie at any future time. This is properly called *flat* money.

Inconvertible paper can pass from hand to hand either because people have no better money and its quantity is limited to such an extent that its evils do not yet appear or because the government is strong enough to compel people to accept it. It must be emphasized, however, that generally its circulation cannot be enforced against public opinion. The most important instances of inconvertible paper money are the Greenbacks issued by the American Government during the Civil War, the French Assignats, etc., issued by the Revolutionary Government of France in 1789 secured by the lands confiscated from the Clergy and the Bank of England Notes issued during the Napoleonic Wars. In the Great War of 1914-1919, all the European countries made their notes inconvertible. Even the Bank of England was ordered to stop payments in specie to people in exchange for paper notes.

Merits and demerits of inconvertible paper money.—Paper money is advantageous inasmuch as it enables real capital to be saved which becomes available for use in other directions. Adam Smith has compared paper money to a wagon way through the air which enables the land under it to be available for raising produce to satisfy human wants. Gold and silver require some capital and labour to produce them which can be employed elsewhere if their use for money is dispensed with. The labour and capital required for their production can be devoted to the production of goods that are directly consumable. This will increase the wealth of the country and raise the general standard of consumption. A second advantage is that loss of wear and tear which is considerable in the use of precious metals as money can be saved when paper money serves as the medium of exchange.

Another advantage is that paper money is very easy to handle and a note of one thousand rupees is as easy to carry about as one of one rupee. Therefore it is more convenient and less expensive also to make payments in distant places through paper money than through metallic money.

There is a fiscal advantage also. A government whose credit is impaired and which cannot raise money elsewhere without paying exorbitant rates of interest can secure this advantage by issuing paper money. This can be done only if the currency of the country consists of metallic money wholly or partly.

The above advantages are not unmixed. The use of paper money is attended by serious drawbacks and evils. Its value is far less stable as compared with that of metallic money. Its circulation depends on the confidence reposed in the government that issues it; while the circulation of metallic money depends upon the force of social habit. The area of circulation of paper money is very much restricted. It does not circulate beyond the political boundaries of a country and the narrow area of its circulation makes its value very unstable.

Its supply can be increased at the caprice of the government and the latter may issue it in increasing quantities even though greater supplies may not be required. The result is that the currency depreciates, prices inflate and an element of uncertainty is introduced in business. Business-men cannot be sure that the values of the goods will remain the same at a future time as they are at the time of making contracts.

This encourages speculation of the worst type. Business sagacity is thwarted and a spirit of prudence and cautiousness gives place to the gambling instinct. The business community is demoralized and a desire to get rich quickly is stimulated among business-men. Security, steadiness and sound business morals go away. It is followed by a large contraction of paper money which is as harmful as inflation.

The fiscal advantage is dearly bought by the community and it is a very unjust method of taxation. It strikes hardest the poor and the ignorant and thus makes the burden of taxation very heavy. The quantity of irredeemable paper money is determined by fiscal needs and not by business needs as it ought to be. Money is really the tool of business and its quantity must depend upon business needs. "Fiat paper has been well called the alcohol of commerce, whose fumes entering the brains of individuals and of government officers, seem to make them incapable of sober judgment or self-restraint in the matter of further issue and further demoralization takes place."¹

EFFECTS OF THE ISSUE OF IRREDEEMABLE PAPER

In a country having purely metallic money as its currency, any surplus of money which it may have will be revealed in a rise in prices. A rise in prices in its markets will increase imports which will have to be paid for in money and the excess of money will go to foreign countries. Any deficiency of money from which a country may be suffering will be made

¹ Kinley, *Money*, p. 351.

good by attracting money from other countries through international trade. This is not the case with fiat money the quantity of which can be and in fact is increased in spite of its low demand from businesses.

When a country using metallic money begins to issue paper, the first consequence is that specie is driven out of circulation. The metallic money goes to the government in payment of taxes or it is used in arts because its price is lowered and hence demand is increased, or it is hoarded by people or exported to meet foreign claims.

If there is no increase in the demand for the medium of exchange in a country, the metallic money will disappear as fast as paper money is issued. But if the demand increases, metallic money may circulate side by side with paper money. If, however, the issue of paper money goes on increasing, it will be able to perform exchanges by itself and metallic money will be driven out of circulation. Up to this point no positive harm may be done. Positive harm arises from over-issue, that is, if it is issued in a larger quantity than the specie it displaces. After this, its further issues will swell the volume of the home currency and bring about a rise in prices.

The first sign of the excessive issue of paper money, *i.e.*, an issue greater in volume than the metallic money whose place it has taken, is a premium on gold. Even when the excessive issue of paper money has been made, some payments must be made in gold. Payments to foreign creditors will be made in gold. Gold must be made available in the form of bullion if it is not in circulation. It will be purchased with paper and some premium will have to be paid for it. This premium will show itself in a rise in the rate of foreign exchange. When paper has depreciated, the importer in the home country has to pay more for the foreign bill of exchange than when the paper money is at par. Such a state is bad for the foreign trade of the country in which paper money has depreciated. The foreign exporter will demand a more favourable exchange in order to offset the premium. The burden of the premium on gold diminishes the profits of the export trade if the country has to make large foreign payments.

Prices are quoted in paper and not in gold when the former has driven the latter out of circulation. Prices rise with every fall in the value of paper money. When the excess of the issue of paper over the specie displaced is small, prices may remain as under the specie regime for custom may not allow them to change. Therefore, though the foreign exchange may rise, prices in general may remain stationary. But the appearance of a premium on gold shows that prices are to rise and that paper money is depreciating.

Prices under a depreciating paper regime rise faster than is warranted by the increase in the quantity of paper money issued. Paper money derives its value solely from its demand for exchange purposes. Its value, therefore, depends upon the confidence that other people will accept it. That confidence grows less as its quantity increases and this lessening of the confidence has no relation with the increase in its quantity. After a certain point many people may refuse to accept it, and its value will fall much more than the proportion warranted by the increase in its quantity.

THE PREMIUM ON GOLD AND THE DEPRECIATION OF PAPER MONEY

The rise in prices of goods in terms of paper money measures the depreciation of paper money. If the prices become 150 the depreciation of paper is 50. A certain quantity of goods can be purchased through paper money as well as through metallic money. It would seem, therefore, that the premium on gold might be equal to the depreciation of the paper money in terms of goods or, in other words, the premium on gold might be equal to the depreciation of paper. To express it in a different way the prices of goods would rise to the same extent as the prices of gold. As Kinley would put it, "The paper price of bullion would be greater than the mint price by an amount equal to that by which foreign exchange is below the real exchange." But it is not really so. The premium on gold as a matter of fact does not correctly measure the depreciation of the paper or the rise in prices. The rise in the prices of goods is greater than the rise in the prices of gold. The premium on gold measures the depreciation of paper only very roughly. "The purchasing power of inconvertible paper money is a little less when measured in goods than it is when measured in gold." In other words, the total depreciation of paper money is greater in goods than it is in gold or the prices of other goods or commodities rise to a greater degree than the prices of gold. There are many reasons for this.

Firstly, there is the risk of an increase in the quantity of paper in the future which will further depreciate its value. This risk has to be taken into consideration and has to be discounted, but this should be the same in case of goods and gold. Really it is not so; because the prices of other commodities cannot be changed as quickly as those of gold. The latter is one commodity and the former are numerous and the prices of some of them might change in one direction; while those of others in the other direction and possibly the prices of some goods might remain stationary. If the prices of other commodities cannot be changed as quickly as those of gold, they

cannot also adjust themselves as quickly as those of gold. The prices of goods will take a longer time to adjust than is the case with the prices of gold. Therefore, the possibility of the discount of risk is larger the longer the period over which it is to be discounted. Hence paper money depreciates in goods to a greater extent than in gold.

Another reason why the depreciation of paper in goods is greater than in gold is due to the fact that prices of other commodities show the full rise caused by an increase in the quantity of paper money. The prices of gold do not show the full rise, because when gold is ejected or driven out of circulation, it lowers its value which is not the case with other goods. The export of gold raises the world level of prices and lowers its own value. An increase in the quantity of paper lowers its value in gold and in goods; but gold falls from its former value and goods do not. Hence the depreciation of paper in goods is greater than in gold.

A third and final cause of the greater rise in the prices of goods than of gold in terms of paper money is due to the fact that the demand for goods is two-fold—a cash demand and a credit demand. Hence prices of other goods rise in a greater degree than the extra volume of paper money would warrant. The same is not the case with gold. Therefore the value of gold does not rise to the same extent as that of other goods. Consequently, the depreciation of paper is more in terms of goods than in terms of gold.

The issue of inconvertible paper money should be carefully regulated in order to prevent over-issue, depreciation and inflation and to avoid all the attendant evils thereof. Some people suggest the measurement of fluctuations in prices according to which the amount of paper money should be enlarged or contracted as necessary. But on account of the imperfection of index numbers, this method will prove to be unsound and practically useless. A premium on gold is a clear proof of the excessive issue of paper. Therefore the quantity of paper money should be so regulated that this premium may be prevented.

CONVERTIBLE PAPER MONEY

Convertible paper money consists of notes for which the issuer is prepared to pay standard money on demand or at the will of the holder. The advantages of convertible paper are obvious. It saves precious metals which can be used for nation-building departments and this involves a saving of real capital. It can be more conveniently handled and causes little loss by wear and tear. In response to an increase in commerce, industries and trade, its volume can be easily increased, for in such cases the quantity of metallic money may not be able to cope with the situation.

It may be issued by the Government or by banks or by a Central Bank. The Government—if the issue comes from the Government—will either keep gold or silver equal to the amount or the face value of the notes put out for their redemption or will issue it on its general credit. Its issue is an advantage to the Government inasmuch as the Government can get revenue without resorting to ordinary forms of taxation. The Government has to incur the expense of keeping and maintaining the reserve against its issue. If the demand for redemption is sudden and very great the whole system is endangered for the reserve cannot be easily enlarged. The enlarged quantity can come only out of increased taxation which is too slow and difficult a process as it is always resented by people or the enlarged quantity can come from the sale of bonds also. The latter method is also open to objections of being slow and difficult. The main objection to the issue of paper money by Government is that it is not in intimate touch with business conditions and, therefore, is not in a position to regulate the volume of currency to suit the convenience of business community. There is also the danger and temptation of over-issue if the issue of paper money comes from the State. The Government in issuing paper money will be generally actuated by fiscal needs and money being the tool of business, its issue does not fall within the scope of the functions of the State.

Its issue, on the other hand, may proceed from the central banking agency of a country. If it is a bank note, it is issued by a bank promising to pay a specified amount in legal tender on presentment to the bearer thereof. The bank notes get into circulation in two ways. A customer may deposit metallic money with his bank and may get the more convenient bank note in exchange thereof; or he may give to his bank his own promissory note or a bill of exchange and get the bank note. In doing this the customer exchanges his own credit for that of the bank. As a merchant he has incurred debts which he has to pay and he could offer his promissory notes to his creditors; but they too like him are in debt and want a medium of payment which can be accepted by their creditors for them. The credit of the merchant is well-established at the bank but not with business community as a whole and the latter will not accept his promissory notes in satisfaction of debts and obligations. But the credit of the bank is well-established and bank notes can pass current, for people have confidence in the bank. Therefore the merchant exchanges his own promissory notes for those of the bank. It simply means that there is the process of exchange of credit of a narrower circulation for credit of a wider circulation.

Thus the issue of bank notes depends on the amount of

the promissory notes and bills of exchange offered to the bank. The number of the latter depends upon the volume of business. If business is brisk and expanding, more promissory notes and bills of exchange will be presented to the bank for exchange for the bank promissory notes and less will be presented if the business is slack. Hence the issue of bank notes will be in response to business needs, expanding with the expansion of business and contracting with a slackness in business. A bank is, therefore, better fitted to regulate the issue of notes than government. This special power of banks to adjust the volume of note-issue to business demands is called elasticity of bank notes. The Government paper lacks this quality, but the bank paper does not.

By elasticity is commonly meant the quality of a body by virtue of which it can expand by drawing it and contract by giving up the pressure. If applied strictly to money, the term should mean that the same quantity of money should be able to do more business under an intense pressure and less under a relaxation of demand. This is, however, not the proper meaning of the term elasticity as applied to money. In case of money it means that the volume of money should increase if there is an increased demand for it and should decrease if there is a decrease in the demand for it.

Metallic money does not possess elasticity, for metal leaves the place where there is less demand for money for a place where there is a greater demand for it. Its total quantity, however, remains the same. Under a system of convertible paper the increased demand for it is met by an increase in its volume or supply which means that more paper money is issued. Metallic money possesses mobility or fluidity and convertible paper possesses the quality of elasticity. "The so-called elasticity of gold money means a changed distribution; that of paper money implies a larger or smaller volume than before in some place or places, but not at the expense of the supply of any other place."

In the last century there was a great difference of opinion between economists on the exact meaning and the desirability of the elasticity of money. Now there is little doubt that the currency should possess the quality of elasticity. There are seasonal demands of agricultural communities which can be met by an increase of the supply of money. Cheques, etc., cannot serve the purposes, for those people are far from the banks and do not know the formalities to be performed in connection with cheques.

The opponents of elasticity say that these local and seasonal demands do not occur everywhere at the same time with the same intensity. At one place the demand for the

medium of exchange may be very strong and at the other place it may be very weak. Money consequently can be transferred from the former to the latter place without causing any irritation and inconvenience. But in answer to this it may be pointed out that there is the expense of transferring money from one place to another and this may be more expensive than the additional local issues.

It is pointed out that the stronger demand will increase the rapidity of circulation and will make an additional supply unnecessary. This is true provided the increased efficiency of the existing monetary supply is enough to meet the demand. But this only means that there are other ways of doing the same thing and the least expensive and the most effective way must be chosen. It is further argued that to prevent speculation the stringency should be allowed to be felt; but it may be said that the increase in demand is not always speculative and that if the supply is not increased some legitimate businesses will be starved. The argument is, therefore, invalid.

For the above reasons, it is very necessary that a good system of currency should possess the quality of elasticity in order to perform its functions in an adequate manner. As pointed out above, metallic money does not possess the desired elasticity, but paper money does. The question is whether paper money should be issued by the Government or by the banks. If the Government issues notes, it does so under a special Act which regulates the note-issue and also the fiduciary and metallic portions of the paper currency reserve. Government issues paper money which is brought into circulation in payment for government dues and cannot be put into circulation as loans to business-men. If, on the other hand, banks are allowed to issue paper they will put it out in response to business needs. The question then is whether the issuing banks should be left free to regulate the mode of issue and the management of paper money and note-issue be regarded a part of the ordinary business of banks or whether the banks should be regulated by law in this matter. In the earlier days there were two schools of economic thought on this question—one supporting the banking principle of note regulation and the other supporting the currency theory.

(a) *The Banking Theory.*—The Banking Theory holds that the issue of notes should be regarded as the ordinary business of a bank and that there is no danger of issuing paper money in excess of the demand for it provided paper money is always kept convertible. Convertibility and good banking are regarded as proper safeguards against any excessive issue of paper money. According to this theory, if the notes are always kept convertible they cannot be issued in excess and

consequently, the evils of inflation and depreciation cannot arise.

(b) *The Currency Theory.*—The advocates of the currency principle point out that bank paper can vary independently of the metallic money in whose place it has been issued and that it can be issued in excess of that metallic money which it replaces. This causes inflation and creates an extra demand for paper money. According to this theory constant convertibility is not a proper safeguard and, therefore, the bank paper must be regulated by law to prevent excessive issue.

There is an element of truth in both these principles ; but it is interesting to note that it is the currency theory which has been put into practice and the Bank of England, the Imperial Bank of Germany and the banks of the U.S.A. are all organized on the currency principle with regard to their power of issuing notes. The Bank of France is an excellent illustration of the Banking Theory. The general experience of all banks is in support of the Banking Theory.

The real issue is whether a bank can issue notes in excess of the demand of the business community. Issuing notes is the same thing as extending credit. A bank gives its notes in exchange for the bills of exchange or the promissory notes of the customers. This operation is known as discounting. Obviously these promissory notes and bills of exchange will be discounted by the holders only when they require money for carrying on their business. Therefore banks cannot issue notes in excess of the demand. The increase in business does not come from an increase in the demand for currency. An increased demand for currency is a consequence of large and growing business and to say that notes can be issued in excess of demand is to mistake effect for cause. The bankers' own interest works against over-issue. If the banks issue more notes than is justified by the demand of businesses, the excess will come to them either to be kept as deposit whereon they will have to pay interest or they will be presented for conversion into specie which in either case will subject the banks to loss.

It does not, however, mean that the issue of notes should not be subject to regulation ; because banking is not always sound and careful, and it is quite possible for people to be carried away by extravagant expectations of business growth and these speculative tendencies can be accentuated by banks by lowering their discount rates. Again, people do not always press for convertibility and notes are not presented for conversion *en bloc* and banks can create confidence against convertibility. A bank may issue notes in excess of the demand and subject the community to all the evils of inflation.

Thus it is necessary to safeguard the issue of convertible paper by banks in some way or other. Various measures have

been advocated and put into practice to safeguard against this evil. (1) One group of these methods seeks to remedy the evil by acting directly on the issue by fixing a limit to the amount that the bank may issue. This theory assumes that a certain amount of money is always needed by the business community and that business requirements cannot fall below that requisite minimum. This amount of currency will be as good as gold, for it will never exceed the demand for money at the current range of prices. This may be paper as well, and it will never be presented for conversion to any great extent. The objection to this mode of regulation is that it makes the currency inelastic and dissociates the note-issue from the close correspondence with business needs and the demands of trade which is very necessary for economic development. Such a measure is in no way different from the currency principle. (2) The second group of methods consists of those which act on the reserve. The regulation of the reserve including not merely specie but bonds, stock and commercial paper also may be effected in various ways.

(a) *The Minimum Reserve Method.*—According to this method the law requires the issuing banks to keep in stock a certain quantity of specie at all times irrespective of the amount of notes put out. This method is prejudicial to good management and affords little protection. The object of such a reserve is two-fold : firstly, to protect the bank against a possible danger of failure to redeem its obligations ; and secondly, to afford relief to people who need money when it is not very easy to get it. These purposes are defeated in times of emergency or a crisis if the bank is to keep the reserve at a certain minimum. This means that the bank should stop converting notes into standard money beyond a certain point and when the reserve falls to the minimum fixed by law some people fear that the notes possessed by them may not be redeemed by the bank. This will induce them to present those notes for redemption and thus the evil which the reserve is intended to prevent will be accentuated.

(b) *The Proportional Reserve Method.*—According to this method the law insists on the bank to keep in reserve a sum which will bear a certain proportion to the note-issue. For example, if the amount of notes in circulation is Rs. 80,000 and the reserve required by law is one-fourth of the issue or Rs. 20,000, the redemption of Rs. 15,000 worth of notes will reduce the amount of notes issued to Rs. 65,000 ; but the amount of the reserve also would be lessened by a corresponding amount and it would fall below the legal proportion. Whatever advantage is possessed by this method comes from fixing the reserve at a high proportion to the total issue.

Though a large reserve would better safeguard the convertibility of notes, it would not involve a great saving of investment in metallic money. It is also open to the same objection to which the minimum reserve method is subject. This system has been recommended for India by the Royal Commission on Indian Currency and Exchange and also by the Reserve Bank Committee.

(c) *The Simple Deposit Method.*—According to this method the bank should keep a stock of specie equal to the amount of notes issued. It may be safe but does not ensure economy except that which arises from the mere saving in the wear and tear of coins. The notes issued are given the character of warehouse receipts or deposit certificates and they do not possess the advantages of bank money. Moreover, the metallic reserve is a great temptation to the authorities in times of treasury distress.

(d) *The Partial Deposit Method.*—Under this method the bank can issue a certain proportion of the notes against stocks and bonds, but all further issues must be supported by a specie reserve. This method is adopted by the Bank of England which is permitted by law to issue a maximum of £17,500,000 of notes on the security of government bonds.² Its main advantage is that as the amount of note-issue increases the metallic reserve also increases proportionally. But on the other hand, it deprives the bank paper of the quality of elasticity. The quality of elasticity in England is secured by the cheque habit in spite of the existence of this system.

(e) *The Bond Deposit Method.*—According to this method a bank is not required by law to keep a metallic reserve; but it can keep a reserve of stocks and bonds and of gilt-edged securities on the strength of which notes can be issued. It is open to various objections. One objection is that the bond security by itself does not secure convertibility of notes and in case of stringency the bonds have to be sold to get gold which will force down the price of bonds and raise that of the gold. Further, the bank has to invest its capital in the purchase of the bonds instead of leaving it free to discount commercial paper. It makes the issue of notes inelastic as the volume of these notes depends not upon the needs of business but upon the value of bonds which will rise if they are to be purchased in large amounts, and therefore, this process becomes less profitable. Moreover, notes issued in this way are not necessarily safer than notes whose issues are based on a partial metallic

² The Fiduciary Issue of the Bank of England was gradually increased from £14,000,000 in 1844 to £260,000,000 at which it now stands. See *The London Money Market*, Fourth Edition, by W. F. Spalding, pp. 48 and 63.

reserve. For if the credit of the Government is impaired the price of its bonds will go down and the security will be lessened. It is also objectionable because it makes necessary a permanent public debt.

(f) *The Safety Fund Method.*—According to this method the note-issuing banks are required to contribute to a common fund of specie which will be deposited with the comptroller of the currency or with some other responsible public official. Out of this fund notes issued by any of these banks will be converted into standard money. If the fund is impaired by such redemptions, it must be restored by further contributions. Its advantage lies in the fact that it leaves the volume of notes absolutely free to respond to business requirements and trade demands and leaves the capital stock of the banks free for ordinary banking business.

(g) *Notes issued on the Strength of the Original Assets of the Bank.*—According to this method no reserve is kept for the convertibility of the notes, but they are to be treated as liabilities of the bank secured on its property and general credit. This system provides great elasticity to the issue of notes and is safe with good banking. But banking is not always safe and prudent and, therefore, this method is likely to cause a greater hardship in times of failure. For this reason when this method is adopted, the notes are made a first lien on the assets of the issuing bank.

A discussion of these methods makes it clear that each one of them has got its disadvantages. It does not seem possible to devise a method of reserve which would secure convertibility, make the currency elastic and at the same time avoid excessive issue, inflation and depreciation. It is quite probable to secure these advantages by a combination of various methods. Any method by which note-issue is regulated must have certain advantages. Firstly, it must result in the greatest possible economy of precious metals leaving the real capital free for the use of the nation-building departments. Secondly, it must avoid the danger of excessive issue and consequent inflation and thirdly, it must ensure convertibility of notes.

CHAPTER IX

Inflation and Deflation

MONEY is only a means and not an end in itself and its importance lies in its worth in terms of commodities. A change in the monetary unit in such a way that it may be uniform in its operations and may affect all transactions and all classes equally is unimportant. An all-round change in the monetary system leaving everything else as before will not produce any new consequences except that more coins or less coins, as the case may be, will be required to affect the same exchanges as before. If the change is such that a man gets twice as many coins as he could get formerly for his commodities sold and services rendered, and if he also pays twice as much as formerly for all acquisitions and satisfactions, he will not at all be affected.

Changes in the value of money or in the price level are important only because their incidence is unequal. When the value of money changes it does not change equally for all; but affects some in one direction and others in other directions. Some are benefited and others injured by a change in the level of prices or by a change in the value of money. The fluctuations in the value of money have been very violent since 1914. The change has been such that it constitutes one of the most significant events in the economic history of the modern world. It has been visited on a society whose economic organization is more dependent than that of any earlier epoch on the assumption that the value of money would be fairly stable. Up to 1920 there was an unprecedented expansion in the supply of currency in all countries which was followed by a contraction of currency in all countries to the same extent.

The former process is known as inflation and the latter as deflation. Inflation means an extraordinarily high expansion of currency and credit beyond the requirements of trade, commerce and industries at the current level of prices. It is generally resorted to by Government in times of emergencies when its credit is very low and it cannot raise money without paying an abnormally high rate of interest. Then it issues inconverntible paper to get the advantage of raising loans without paying any interest. Inflation may also be brought about by banks when they are given the power to issue notes without any law regulating their issues. Deflation, on the other hand, denotes a contraction of currency and credit relatively to trade requirements at the current price level. This like

inflation implies a deliberate action on the part of the monetary or currency authority. Prof. Keynes defines deflation as "The policy of reducing the ratio between the volume of a country's currency and its requirements of purchasing power in the form of money so as to increase the exchange value of the currency in terms of gold or of commodities."¹ In other words, it is a process by which the internal value of the monetary unit is raised with regard to commodities and services. This increases the purchasing power of money and involves a fall in prices, wages and salaries in terms of the monetary unit.

Both these processes alter the distribution of wealth between different classes of society and also affect the production of wealth and both involve grave injustice to the different classes of people. Inflation is more injurious in the sphere of distribution and deflation in that of the production of commodities. We shall first consider the effects of inflation on the various classes of people. For the purpose of this enquiry Keynes has on the principle of convenience followed a triple classification of society into (1) The Investing Class, (2) The Business Class, and (3) The Earning Class. Though the division is not clear-cut because the same individual may be doing all these functions, yet it is none-the-less real.

1. *The Investing Class.*—Many of the purposes served by money depend upon the assumption that the real value of money is constant over a period of time. This is the assumption underlying the contracts for the investment of money. People invest money in bonds, debentures, shares, etc., on the assumption that the value of their investment will not change adversely during the time of the continuance of the contract.

The investment system existing at all times and being associated with money economy developed a new and increasing importance during the 19th century. This is one of the concomitant phenomena of modern capitalism. With the development of modern capitalism the management of property has been separated from its ownership. Those who are the owners of property in modern times seldom manage it themselves. The function of managing affairs is delegated to what are known as entrepreneurs. The proprietor in some cases may retain the ownership of the property, but may part with its management. This is typified by a holding of ordinary shares in a joint-stock company. The ordinary shareholders in such concerns are the owners of land, buildings, machinery and everything else, but they are not the managers of the concern. In other cases the proprietor while parting with the property temporarily is to regain it at the expiry of a

¹ See Keynes, *A Tract on Monetary Reforms*, p. 142.

stated period of time and receives a fixed sum of money annually in the meantime, *e.g.*, in the case of lease. In other cases, the owner may permanently part with the property in return for a perpetual or terminable annuity. In the latter event, the principal sum of money is to be repaid at the end of the term, *e.g.*, mortgages, bonds, preferential shares, etc. All these are typical cases of investment, but the last type in which the ownership and management are completely separated represents the full development of investment.

With the advent of modern capitalism the propertied classes have been divided into two groups—the business-men whose income is known as profits and the investors whose income is interest and rent. This separation of functions has enabled the entrepreneurs to undertake the risks and utilise their own wealth and that of the community. This system has also enabled the professional and the propertied classes to find an employment for their resources with little trouble and responsibility.

The system facilitated the growth of wealth on an unprecedented scale and brought the vast production of goods made by machine within the means of ordinary people. It was responsible for the change and transformation that took place in the 19th century in all European countries in the organization and size of industries. The real cause of all this progress lay in the separation and specialization of functions brought about by the facilities of investment. "The savings were seldom drawn on, and, accumulating at compound interest made possible the material triumphs which we now all take for granted. The morals, the politics, the literature . . . joined in a grand conspiracy for the promotion of saving. God and mammon were reconciled."

The system worked with facility and brought about the expansion of businesses. But the investing class depended much upon the stability of money. The confidence in the stability and safety of a money contract became rooted in the very nature of the people. But the value of money never remains stable for long. In the past also from the earliest times owing to the financial necessities of governments and the superior influence of the debtor class or business-men, inflation has been resorted to. But the way we use money in daily life makes us forget the fact that its value can depreciate and we begin to look on money as the absolute standard of value.

It is only natural for a man to regard as permanent what has been normal for about three generations. The course of events during the 19th century favoured such ideas about the stability of the value of money. Up to 1914 for about one hundred years the prices were fairly stable. The maximum fluctuation in either direction was 30 points, the index number

never rising above 130 and never falling below 70 (1896). Gold standard had thus proved reliable in practice.² It was not a surprise, therefore, that the investing class looked upon the stability of the value of money to remain permanent. In the early part of the 19th century the investor had done very well in three ways: (1) the capital value of his investment had appreciated because of a steady fall in the rate of interest, (2) the purchasing power of the annual money income was increasing, and (3) the investment was a good one. Custom and experience had acquired for such investments an unimpeachable reputation for security.

These fortunes already began to suffer some loss after 1890 from a rise in prices and in the rates of interest. But after 1914 their loss became considerable and the monetary events after the War took from them about one-half of their real value in England, seven-eighths in France, eleven-twelfths in Italy and virtually the whole in Germany, Austria, Russia, etc. Between 1896 and 1914 the English investor lost about a third in the capital value of his annuity and in the purchasing power of the income and between 1914 and 1920 the loss was again of one-third and two-thirds in the capital value of the annuity and in the purchasing power of the income thereby respectively.

There were, however, two circumstances mitigating the loss. During the War the savers saved much and invested same in government securities and with their larger holdings of the government securities had increased aggregate money claims on the Exchequer. Secondly, the investing class which lost money was overlapped both socially and by family ties with the business class which made sufficient money up to 1922. In short, it can be said that inflation is injurious for people getting fixed incomes by way of interest and rent and, therefore, discourages savings also inasmuch as savings come from this class. Inflation is injurious to creditors as a class for they receive less in terms of commodities as the value of their money income falls in terms of commodities.

2. *The Business Class.*—A period of rising prices due to inflation of currency stimulates enterprise and benefits business-men. It is advantageous to debtors inasmuch as they return much less in the form of commodities when they pay their debts in a depreciated currency. Those who pay fixed sums of money yearly stand to gain because their fixed money payments will bear a much smaller proportion than formerly to their money turnover when the currency has depreciated. This is so even when the prices settle down at the higher level. In Europe the farmers who had raised by mortgage the funds to purchase their lands gained much at the expense of the

² See Keynes, *A Tract on Monetary Reforms*, p. 127.

creditors. In the transitional period when the prices rise month by month, business-men gain much because they buy before they sell and in the meantime the value of their articles appreciates much with every fall in the value of money. They can make great fortunes in a few months if the rise in prices is very rapid. Further, business-men being debtors inasmuch as they borrow money stand to gain much, for they pay negative interest even though the rate of money interest is a positive sum. Suppose in a period of rising prices a business-man borrows a sum of money which is worth 100 in terms of commodities and agrees to repay it at the end of the year at 5 per cent. per annum. When he returns that sum of money the value of money has fallen or which is the same thing as saying that prices have risen and, therefore, at the end of the year it represents, let us say, 90 in terms of commodities. At the end of the year he returns at 5 per cent. only $95\frac{1}{2}$ in terms of commodities. The lender has got only $95\frac{1}{2}$ even though he lent 100 in terms of commodities. The real rate of interest is, therefore, *minus* $5\frac{1}{2}$ per cent. though the money rate of interest is 5 per cent. because for every 100 in commodities the borrower returns only $95\frac{1}{2}$. In the same way if at the end of the period the real worth in commodities of the sum of money becomes 110 while it was 100 only in the beginning, the real rate of interest becomes $15\frac{1}{2}$ per cent.

Business-men thus gain in a period of rising prices. It is true that if the rise of prices is foreseen, the money rate of interest also moves upwards, but it can never be so high as to neutralize the gain to debtors. In other words, the money rate of interest in a period of rapidly changing prices seldom adjusts itself in such a way as to prevent the real rate from becoming abnormal. In Germany in 1923 with the final collapse of the currency the money rate of interest reached the stupendous figure of 100 per cent. per month, but the rate of currency depreciation was so great that the borrowers were still making money.³ Similarly, in a period of falling prices even one per cent. bank rate is oppressive to business-men.

In a period of rising prices business is demoralized for that element of certainty and confidence which is the foundation of progress gets paralysed and among business-men a spirit of getting rich quickly is fostered which encourages speculation of the worst type. Further, enterprise is discredited because the high profits of business-men are regarded as causes of rising prices and they are looked with an air of suspicion reaping the gains for themselves. If the fall in the value of money discourages investment, it also discredits enterprise. But one advantage of rising prices is that the gains to business-men encourage savings from investors.

³ See Keynes, *A Tract on Monetary Reforms*, p. 247.

3. *The Wage Earning Class.*—It is a common notion that during a period of rising prices wages lag much behind prices and labour class as a whole is hard-pressed. But Mr. Keynes is of opinion that though this may have been true in the past and may be true even now with regard to ill-organized labour, important sections of labour in the U.S.A. and England gained much in this period following the break-up of the War. According to him, they could obtain money wages equal in purchasing power to what they had before, and besides, secured a real improvement in their situation in the form of reduction in hours of work. It was due to the existence of organizations among labourers and also because employers or business-men had been gaining notoriously rich and could afford to share the windfall gains with labour. Public opinion in such times was with labour and the employers, therefore, shared with workmen the good fortunes of the day.

In fine, inflation is injurious to the investor, beneficial to business-man and in modern industrial conditions probably it is beneficial to labour as well. Inasmuch as it is injurious to the investor, it discourages savings and thus discourages the growth of capital also. The distinction between capital and incomes is confused in such times and the increasing money value of capital obscures a reduction in the real quantity of capital stock. In such times a community fails to make good its current depreciation.

Deflation has opposite tendencies. It benefits the investing class at the expense of the business class and labourers also generally suffer the consequences of unemployment and low money wages although as consumers they stand to gain. We have already seen that a change in the measuring rod of value affects a redistribution of real wealth between the three classes of society. The business-men, the active members of society, can minimise their losses or increase their gains if they can foresee such changes in prices. If they expect a fall, they will reduce production and minimise their losses though society as a whole is impoverished by such enforced idleness. If they expect a rise, they will swell production by increasing borrowing. In other words, the intensity of production is largely governed under the existing conditions by the anticipations of real profits by the entrepreneurs. Modern production owing to the very technical processes involves risks and these risks increase with the increased complication of the technical processes of manufacture. The extent of the risk and the length of time through which this risk must be carried are much greater than they would be in a self-contained society. This increased risk is the price which society has to pay for the advantages of a high degree of specialization.

To provide facilities for the undertaking of this risk is one of the greatest problems of modern economic life.

A considerable part of the risk is due to the fluctuations in the relative value of a commodity compared with that of commodities in general during the period of the commencement of production and the time of sale. This risk is independent of the vagaries of money. But a portion of the risk is due directly to instability in money value. The disadvantages of a depreciating currency have already been considered. There are great hardships owing to deflation also. A general fear of falling prices decreases production. Entrepreneurs in such circumstances are reluctant to undertake risks. Falling prices injure them because when they sell goods, prices become lower than when they make payments to various kinds of labour and purchase raw materials. Thus the fear of falling prices causes them to curtail production. Since 1921 onwards up to the present day prices have been going down in all countries and business depression is growing. Trade is falling and mills and factories are working at losses. In India specially, the present depression is largely due to deflation brought about by the maintenance of the 1s. 6d. ratio.

Deflation bringing business depression in its train causes unemployment. Some mills work part time and others stop work entirely and hence some labourers work part time and others have to go without work.

Creditors, on the other hand, gain because the value of money appreciates between the time of their making advances to debtors and the time when they receive their money back. The purchasing power of their money increases. People with fixed incomes also benefit to the extent of the increase in the value of their money income. Salaried-men and wage earners stand to gain as consumers because of falling prices; but probably there is a net loss to them because of a fall in their money earnings and because of an increase in unemployment.

We see then that inflation and deflation have their characteristic disadvantages. The former is unfavourable to savers and the latter to producers and labourers. Deflation causes injustice to borrowers and inflation over-stimulates production. On the whole, deflation is much worse than inflation, because it is worse to promote unemployment than to disappoint the rentier. But one evil is not to be preferred to another and both are to be shunned. Currency disturbances, therefore, should be carefully checked by deliberate decisions on the part of the currency authority.

CHAPTER X

Currency Reforms

WE have seen in the last Chapter how important it is that the measuring rod of value should be stable and that fluctuations in it should be reduced to the minimum. We have also considered the effects of inflation and deflation on the currencies of various countries. In this Chapter we shall suggest some of the reforms that should be carried out in such cases. It must, however, be made clear that remedies applied in one country may not be applicable to the conditions of other countries and, therefore, different policies necessitated by differences in conditions should be followed.

In most countries the instability in the value of money has been due to two causes : the failure of the national currencies to remain stable in terms of the standard of value or gold ; and the failure of gold itself to remain stable in terms of purchasing power. Some people believe that the restoration of the gold standard or ensuring the convertibility of each national currency at a fixed rate in terms of gold will achieve the object and that, therefore, the main question is whether to restore the national currencies to their pre-war level, *i.e.*, the pre-war gold value or to the present value. This is a case of deflation *versus* devaluation. The following relevant questions are to be considered whenever the currency stability is to be brought about after the effects of a catastrophe like the Great War.

(a) *Devaluation versus Deflation*.—Should we fix the standard of value at the present value or the value existing at the time of currency reforms—the standard may be gold or not—or the standard of value should be restored to its former level or value ? (b) Should we aim at stability of prices or at stability of exchange ? *i.e.*, whether our aim should be at stabilizing the value of the currency of a country in terms of internal purchasing power or in terms of the currencies of certain foreign countries ? (c) Is a gold standard the best available method in practice ? These were the questions before the statesmen of the various countries of the world prior to the restoration of their currency systems.

(a) *Devaluation versus Deflation*.—The policy of stabilizing the value of the currency of a country somewhere near its present value without taking into consideration its pre-war value is devaluation. On the other hand, deflation means a reduction in the quantity of the currency of a country to appreciate its value in terms of purchasing power. In other

words, stabilization of the currency at its former value means deflation and stabilizing its value at the present depreciated value means devaluation. Up to 1923 the policies of the various countries were not clear whether they were trying to stabilize their currencies at the pre-war levels or at the post-war levels. Most countries wanted the pre-war levels ; but they failed in their attempts. Later on, probably they realized their mistakes and gave up their idea of stabilizing the currencies at the pre-war levels.

The main arguments against deflation are : (1) It has very disadvantageous effects as it changes the existing standard of value and its effects on distribution of wealth are injurious because it involves a transference of wealth from other members of society to the investors. It also means transference of wealth from borrowers, *i.e.*, traders, manufacturers, farmers, etc., to lenders. (2) Its effects are very harmful to business and social stability. The policy of raising the value of money means a fall in the value of goods or, in other words, a fall in prices which gives a great set-back to businesses. It leads to a fall in the value of goods and stocks that are lying in the godowns of merchants. They will, therefore, like to dispose of their goods to prevent a further fall in their value and to save them from further losses. This in itself aggravates the tendency of prices to fall. Moreover, when the value of money is expected to rise, the borrowers in repaying their debts will have to pay more in terms of commodities and this leads to an increase in their liabilities. Therefore they like to curtail borrowing and as businesses are carried on with borrowed money, it curtails businesses also. (3) Another argument is that deflation in sufficient degree to restore the currency to its former level is not possible specially when inflation continues for long as during the war time, for the burden on the tax-payer would be extraordinarily heavy. To pursue this policy in practice is impossible ; yet many countries by prolonging this process obstructed the course of currency reforms.

Thus restoration of currencies to pre-war levels was neither possible nor desirable. But then why was it that certain countries tried to follow this policy in spite of its disadvantages ? This brings us to the main arguments in favour of deflation. (1) To leave the currency at the existing level means an injustice to the creditors and to those who get fixed money incomes. It is, therefore, a breach of contracts and to restore its former value would be an act of honour. It is claimed for deflation that the raising of the purchasing power of money is necessary in the interest of pre-war holders of stocks and other fixed interest-bearing securities. It is true that inflation has done real injury to them and ideal justice would require the restoration of the purchasing power of gold

to its pre-war level. But this class of interests cannot be treated separately. There are holders of war-loan bonds whose contracts are comparatively recent. Deflation would not only restore the value of pre-war bonds, but of post-war bonds also and thus the total claims of the bond-holders would be raised beyond their real claims. Great injustice would be caused to a great majority of debtors in order to do justice to a minority of creditors. Most of the money contracts still outstanding were entered into when the real worth of money was what it was at the time of currency reforms and not what it was in the pre-war days. The great mass of such contracts being of very recent origin, all of them do not require the same treatment. The pre-war bond-holders could not be treated separately and, therefore, deflation is undesirable. (2) Another argument for deflation is that the restoration of currency to the pre-war level would raise a country's financial prestige and create confidence for the future. This argument is valid only where inflation or the fall in the value of money has not existed for long and, therefore, when the currency can be restored to its pre-war level at an early date. But if inflation has continued for a long time so that the restoration cannot be to the pre-war level, there is no use to raise the value only by a little. The restoration, if it was to take place, should have been the exact pre-war level. The financial prestige of a country cannot be enhanced by raising the value of its currency only to a partial extent. Therefore in cases where the currency has suffered a severe and prolonged depreciation, the right policy is devaluation at the existing value to which commerce and wages are adjusted. (3) Deflation is said to be advantageous because it reduces cost of living and benefits labour. A rise in the value of money means that the same quantity of it will procure more goods and, therefore, labour will save its money income. But this is only a delusion because a fall in the price of commodities will also mean a fall in the price of labour and if money will purchase more goods, it will also purchase more labour. Therefore the money income of labour will decrease. (4) It is also pointed out that deflation will enable foreign goods to be purchased more cheaply and that the burden of foreign indebtedness fixed in terms of gold will be discharged with less efforts. But if imports fall in price, so will exports fall and on the whole there may be no advantage. Importers may gain but exporters will lose. As foreign debts are paid for by exports, the burden of such indebtedness will not decrease. Devaluation is preferable to deflation specially when inflation is long-continued.

(b) *Stability of Prices versus Stability of Exchange.*—The rate at which the currency of a country will exchange

with that of other countries depends upon the relation between the price level of that country and that of other countries. It follows that it is very difficult for exchange to be stable unless both the internal price level and the external price level remain stable. The external price level is out of control. Then either a country must have control over internal price level or allow its exchange to follow the external price level. It is desirable and expedient to keep internal price level stable. Before the Great War when every civilized country was wedded to the gold standard, stability of exchange and not stability of prices was the aim. The main reason was that the price fluctuations were moderate though the fact that people did not like to trust themselves to a less automatic but more reasoned policy of stabilizing internal price level was another cause for aiming at stability of exchange.

Whether stability of exchange or of prices should be the aim will depend upon different circumstances in various countries. It will depend partly upon the relative importance of the foreign trade of every country. But the achievement of stability of internal price level seems more desirable. Stability of exchange is convenient only to those engaged in foreign trade and contracts and business expectations depending upon exchange are far less than contracts which depend upon the course of internal prices. This is the case even with a country like England whose foreign trade is very important.

The main argument in favour of stability of exchange seems to be that it is easier to attain stability of exchange, for it requires that the same standard of value should be adopted at home and abroad. On the other hand, internal price level can be stabilized by keeping index numbers and having faith in their accuracy, but index numbers are not very often reliable. Stability of exchange is not desirable for two reasons. In the first place, it is not as easy to attain as it is thought to be and it requires a more thorough examination than it is often given. In India though by chance than by deliberate efforts internal price level remained fairly stable at the expense of a fluctuating exchange during the war and if the Government of India would have tried to fix the rupee-sterling exchange, price fluctuations here would have been disastrous. A second argument is that stability of exchange is not attainable if different countries adopt different standards of value. Before the war gold had afforded not only a stable exchange but a stable price level as well and in the absence of stability of prices even a gold standard would not have been adequate for stabilizing exchange. Before the discovery of South African gold mines, when prices were falling owing to money being less than the requirements of businesses at the then prices, the bimetallists had advocated the

adoption of double standard for the gold standard. The fluctuations in prices before the war were not as great as after the war and had they been so great it is doubtful whether they would have been properly dealt with by the pre-war system.

In pre-war days internal prices were adjusted to the exchange with outside world only very slowly. The system in pre-war days was too slow in its operation in adjusting the internal prices to the external ones. The fault of the post-war regime under which the price level mainly depends upon internal currency and credit policy and the rates of exchange have to adjust themselves to it is that it is too rapid and may act violently for only transitory causes. But when fluctuations are sudden and large, a quick reaction for maintaining equilibrium is necessary and desirable. Therefore the pre-war method is inapplicable to conditions after the war.

According to the pre-war method an adverse balance was redressed very slowly through bank rate. If gold flowed out of the central reserves, the bank rate was raised and credit was curtailed. This reduced the currency and made the goods which were sensitive to the ease of credit very cheap. The influence was gradually spread to the prices of goods entering into the international trade until at the new level foreign goods in the home country became dearer and home goods abroad became cheaper. This stimulated exports and discouraged imports and thus the adverse balance was redressed.

This method takes a long time and gold reserves might be depleted much before compensatory forces worked, and in the meantime the rate of interest might have attracted foreign capital or encouraged investments in foreign countries before the internal prices were set right. But the post-war method is much more quick and proved fairly successful immediately after the war. With the pre-war method the discount policy is all powerful for bringing about equilibrium between the internal and the external price levels ; but with the post-war method, the bank rate is an instrument for influencing the internal price and through this the exchange also. Exchanges can come to equilibrium without its aid.

(c) *The Gold Standard.*—Under a gold standard, as already pointed out, the standard money is of gold whose face value is equal to its intrinsic value. Only the standard money is made full legal tender ; but this does not mean that other media of exchange do not circulate. Currency notes, token coins, cheques, etc., may be and in fact are in circulation. What is necessary is that the convertibility of these other media of circulation should be ensured in standard money. The face value of token money should be kept at a fixed gold value either by the direct convertibility of the tokens into gold or by convertibility into foreign credits which are maintained

at a fixed gold value. Or it may be that their supply may be so limited that though inconvertible, yet they may circulate alongside gold coin. It has also a free mint and people can present gold bullion to the mint and get it manufactured into coins. The monetary unit is equated to a prescribed quantity of the commodity. With a good banking system the banks supply to their customers the necessary gold for their daily requirements.

This system was prevailing before the war in nearly all countries except India and China. The monetary unit was uniform not only in time but in space also. A trader could not only exchange a credit for future credit in his own country alone, but he could do so for a credit anywhere in the world. It means that stability of the standard was at a fair level. This system worked fairly smoothly up to the War and prices remained fairly stable, equilibrium being established after slight disturbances. But it did not work well during the war and belied the implicit confidence with which people had come to regard it. The governments of Europe could not finance war by taxation or by genuine loans. They issued floods of inconvertible paper and gold was gradually banished from circulation. Enormous stocks of gold went to America where also currency inflation became great and the purchasing power of gold declined. This fact disclosed a weakness in the gold standard.

The stability in the value of gold depends upon the fact that the accumulated stocks of gold are large in comparison with its annual supply. But this also means a large quantity of gold coins in circulation. This large demand for currency implies the withdrawal of a large quantity of gold from other uses and this tends to keep the value of gold up. Floods of paper money send gold out of circulation and the supplies, being great in proportion to its demand for industrial purposes, have to be absorbed as currency in the area in which gold is in circulation. The value of gold will fall much if the area of its circulation is very restricted. America with a few minor countries being the only country in which gold was in circulation experienced a great fall in the value of gold.

The question of stabilizing the standard of value became of great importance during and after the war. For deciding the value of the future monetary standard, two questions should be considered : firstly, the depreciation of the currencies in terms of gold and secondly, a fall in the value of gold itself. The real issue is that such a standard should be required which will remain stable in time and space, i.e., its value will remain the same at different times and over a wide area. The first one—deflation *versus* devaluation—has already been considered. People had to see whether a return to the gold standard was desirable and possible or not. After the war all

the important countries which had their currencies on a gold basis before the war adopted the gold standard. England adopted it in 1925 followed by other countries. Now England has temporarily suspended the gold standard in order to preserve her gold reserves according to the announcement of 22nd September 1931, and other countries have followed.

Mr. Keynes in 1923 did not think it desirable to restore the gold standard ; because he thought that those conditions which were responsible for its good working in the past did not exist in 1923. Others of the school of thought of Mr. Hawtrey believed in the efficacy of the gold standard and preferred it to a managed currency. Let us recapitulate the arguments employed by Mr. Keynes to discard the gold standard.

(1) In the pre-war days the gold standard proved effective, because the progress in the discovery of gold mines roughly kept pace with the progress in businesses, trade, commerce and industry. This stage is now past and in future gold may either be too dear or too cheap. Since the lapse of about 25 years no discovery has so far been made of any important gold deposits. What has been in the past may not be likely to take place in the future.

(2) In pre-war times the value of gold depended upon its demand for a variety of uses and a sufficient portion could find its way into the hoards of Asia without any flooding of the market. This made the value of gold independent of the policy or decision of a few countries. But the war produced a great change in this direction. Gold itself became a managed currency and the U.S.A. could maintain its value with great difficulty by artificial means by following a costly policy of burying in its vaults the redundant supply of gold. If the gold standard would be adopted, Mr. Keynes thought that its value was likely to depend upon the policy of three or four most powerful central banks acting in union or independently because the necessary gold reserves of the banks of the gold standard countries were likely to be much less than the available supplies of gold. Mr. Keynes' prediction in this respect seems to have come out literally true and most of the gold supply of the world is with the U.S.A. and France and they do not want to part with their supplies. The future of the gold standard entirely depends upon the decision of the central banking institutions of these countries.

(3) Mr. Keynes also believed that the U.S.A. might demonetise gold to prevent a fall in its value and that the then policy of accepting unlimited amounts of gold was only a temporary measure. The U.S.A. also has given up the gold standard now.

As the gold standard in the future was likely to depend on the judgment of the statesmen and finance members of a few

countries, Mr. Keynes objected to its adoption in practice. He did not think that any escape from a managed currency could be possible and, therefore, he discarded the gold standard. "In truth, the gold standard is only a barbarous relic;" and, therefore, he did not desire its adoption. It is true that the main object is the preservation of the stability of business, prices, and employment and for this reason the stability of the value of money is exceedingly necessary. As Mr. Keynes thought that it was not possible to achieve these objects by restoring the gold currency, he did not favour its adoption.

Mr. Hawtrey, on the other hand, favoured the restoration of gold not as a natural or automatic currency, but a managed one, *i.e.*, that the absorption of gold for currency purposes should be kept in control and the demand for gold should be regulated so that the value of the currency unit may not vary much. This would require the co-operation of important banks in various countries. He regarded international co-operation not an easy matter; but as England and the U.S.A. in his opinion were the most important money markets, the system could work with their co-operation which he regarded as possible. He favoured its restoration owing to three reasons: (1) that gold would be necessary for making international payments, (2) that an experiment could be made without deviating from the old policy, and (3) that the vested interests of gold producers justified a return to gold. But for Mr. Keynes gold lost its stability and he discarded it, because "I feel no confidence that an old-fashioned gold standard will ever give us the modicum of stability that it gave. I reject the policy of restoring the gold standard on its pre-war lines."¹

¹ Keynes, *A Tract on Monetary Reforms*, p. 176.

CHAPTER XI

The Gold Standard

AT the present time the gold standard has ceased to function over the greater part of the globe. The Argentine and Uruguay suspended gold payments in December 1929 and allowed their exchanges to depreciate. Canada introduced temporary restrictions at the end of 1929 and the exchanges of Brazil, Chile, Venezuela, Paraguay, Peru, Australia and New Zealand fell in 1930 and remained below gold export point. The United Kingdom abandoned the gold standard in September 1931. Before the end of October 1931 all the British Dominions excepting South Africa, the rest of the British Empire, the three Scandinavian countries, Portugal, Egypt, Bolivia and Finland had all departed from gold. Japan followed in December 1931, Greece in April 1932, Siam and Peru in May 1932, South Africa in December 1932, and the U.S.A. in April 1933. In the summer and autumn of 1931 nearly all the countries of Central and Eastern Europe had placed restrictions on dealings in foreign exchange and in other continents also the same course has been pursued by a number of countries. The Royal Commission on Indian Currency and Exchange in 1926 wrote :—

“We do not indeed regard the possibility of sterling again becoming divorced from gold as of much practical likelihood ; it is unlikely to happen except in a worldwide catastrophe that would upset almost all currency systems.” (Page 11.) The “worldwide catastrophe” came within less than five years of the writing of the above words by the Commission. By 1926 nearly all countries had readopted the gold standard and it worked well up to 1929.

Before discussing the causes of the fall of the gold standard its mechanism and working and the changes introduced in it in recent times may be explained. The gold standard is not a rigid and fixed mechanism, but a system of monetary and credit policy which developed gradually in the light of experience and adapted itself to changes in economic circumstances. To understand its working in recent years, the major changes introduced since its adoption in the second half of the 19th century may be given. It should be noted that never in its history has the gold standard been simultaneously applied in exactly the same manner in all countries which adhered to it. Very different credit policies have been pursued by various countries from time to time. The account given below is “rather an abstract description of leading tendencies than an exact reflection of the complex and intricate evolution of events.”

NORMAL FEATURES

The normal features of the gold standard in its simplest forms will be as follows: (1) the Government should accept gold without limit at a fixed ratio for minting it into coin; (2) there should be free circulation of gold coin as full legal tender, and (3) there should be no restrictions on the import and export of gold. If gold were the only medium of exchange, it would have a direct effect upon prices by its movement from place to place. An illustration will make it clear. If the exports of a country exceeded her imports, the favourable balance of trade would be liquidated in gold which would go into circulation. Incomes and prices would rise. With a rise in incomes, the demand for foreign goods where no rise in prices took place would increase and this should be strengthened by rising incomes in the country importing gold. Its exports would fall because of a rise in the prices of its goods. Hence reverse forces would be set in motion leading to the export of gold sooner or later. In the other country from which gold has been imported, money incomes and prices would have been reduced, exports stimulated and imports discouraged. The influence of gold movements would thus be automatic and reciprocal.

Even in the 19th century the gold standard as described above was not prevalent. Some system of banking was already in operation and some form of medium of exchange other than coin was in use. But it must be noticed that these things may only modify the sequence of events; they do not fundamentally alter the forces at work.

In almost all gold standard countries before the war, payments were made through coins, notes and cheques whose proportion varied from country to country. The amount of notes issued was restricted by law and a relationship was also established between the volume of sight deposits and that of other media of exchange by the cash ratios generally maintained by commercial banks. When gold was imported, a part of it went into circulation directly, part into the reserves of commercial banks and part into the reserves of central banks. The effect of gold imported, therefore, depended upon the manner in which it went into these various uses. If the whole of it went into circulation the addition to circulation would be equal to the amount of gold, but if it went into the reserves of banks also, the addition caused to circulation was much greater. Under such circumstances, the effect of gold movements upon the total media of exchange or the effect of that total upon prices cannot be said to be automatic or inevitable. Banking policy may have a direct influence upon the media of exchange and an indirect influence upon prices.

Before the war the instrument of control used by central banks was their discount or bank rate, variations in which had an influence upon the gold movements and upon the domestic credit structure. The bank rate varied inversely with the gold reserves of central banks; but even this tendency towards automatic alterations in the bank rate was neither absolute nor universal. Free export of gold was not always resorted to. Silver or other means could be offered in exchange for notes in place of gold and thus influence over gold movements could be exercised. Others kept very huge reserves which they could use before altering their bank rate. But the general result of the system as actually applied was to allow gold by its direct and indirect influence through the bank rate to maintain international equilibrium.

Even in its simplest form the gold standard was an integral part of the whole economic organization and not self-contained or self-acting. The use of bank notes and other forms of paper money was well-developed before the adoption of the gold standard as the principal mechanism of international payments and valuation. Monetary mechanism and non-monetary factors such as the volume and nature of production and the balance of commodity trade have always been recognized as interdependent.

Towards the end of the nineteenth century and in the beginning of the twentieth century the mechanism of the gold standard was that the aggregate means of payment consisted of gold coins, bank notes and sight deposits to which various forms of subsidiary coins were also added. From free circulation, gold moved into and out of bank reserves and the latter also included silver and foreign exchange in some countries.

RECENT CHANGES IN THE GOLD STANDARD

The more important changes introduced into the system before its recent breakdown were:—

(a) In many countries gold coins ceased to circulate in practice and gold was concentrated in central banks. This introduced economy in gold use, but increased at the same time the potential influences of gold movements. Gold could exercise a maximum influence over currency as it served the foundation of the credit structure and the power of central banks to influence the situation was increased.

(b) The central banks could not be compelled to convert notes into gold coin. They could give gold bullion or foreign exchanges at their option in exchange for notes.

(c) Banks empowered to convert their sight claims on gold were allowed by the banking laws to keep the whole or part of their reserves in the form of such claims. This measure also afforded an economy in the use of gold at least to the

country holding such assets. But the country on which such gold exchange constituted a claim might be compelled to keep large gold reserves to meet these claims.

(d) Banks enjoying this alternative generally held in their reserves gold exchange on certain international monetary centres, principally New York and London.

(e) In such cases the new legislation expressed the total reserves as a definite percentage of total outstanding notes and sight deposits of central banks, and though not new the percentage reserve system came to be more generally adopted in recent years than before the war.

(f) The ratio of legal minimum was increased and central banks kept higher reserves than required by law in order to meet some drain. The demand for gold for central banking reserves was thus increased considerably in view of this type of central banking legislation. On the other hand, the keeping of foreign exchange in legal reserves economised the use of gold. This alleviated the strain on the gold resources of the world, but the need for a large safety margin in gold was not reduced.

Post-war changes, in part tended to economise the use of gold and in part to increase the demand for it. They required a more deliberate control on the part of central banks whose task thus became very difficult and delicate. In certain countries during the last few years the power of commercial banks and other financial institutions increased much which made the control by central banks more difficult. Moreover, the quantity of liquid capital has, in recent years, been abnormally large because of a feeling of uncertainty which had added to the difficulties of central banks.

The successful operation of any banking system, central or commercial, depends upon the acceptance of certain common principles and conventions by its members. If an important commercial bank decides to modify its cash reserve ratio suddenly, it can force inflation or deflation upon the whole system in proportion to the extent of the change and its importance in the system. In central banking the banks of lending countries exercise the greatest influence as they can influence the movements of gold and the rates of interest in foreign centres also. This power has been with the U.S.A. and France in recent years.

CENTRAL BANKING

The central banking institutions have operated the gold standard on widely different principles. Central banking policy since the war can be divided into two periods. In the first period before 1925, the United States was the only important commercial country on the gold standard and

received large quantities of gold which led to over-expansion of currency. After 1925 many countries returned to the gold standard and co-operation became possible among central banks.

In 1928, however, difficulties arose and national and international factors in monetary policies could not be reconciled. Great Britain was constantly on the economic defensive, for it had returned to the gold standard under conditions which necessitated a fall in domestic prices and some prices proved too rigid. Hence her export trade fell off and unemployment increased and as Great Britain lent freely abroad there was a danger of a drain of gold. In the U.S.A. cheap money policy was initiated in 1927 which led to credit expansion owing to which rediscount rates had to be raised later on. In France a different policy was followed. Until the stabilisation of the franc, the surplus balance of payments was not imported, but accumulated abroad. When the franc was stabilized gold imports took place which were heavy in 1930 and 1931. The Bank of France prevented the influx of gold by increasing investments in foreign countries. It reduced discount rates, and favoured short-term foreign investments to achieve this object.

These measures did not have full effects because of a break in confidence. France, on the other hand, became a refuge for foreign capital which brought large gold reserves into the country in 1930-31.

The above discussion proves (1) that no international monetary standard can successfully work if it varies widely from country to country, and (2) that whenever the general price level in a country important to the whole system is not on a par with world values or becomes insensitive to monetary influence, a great strain is placed on the international monetary standard which it may not be able to bear.

As already pointed out, the mechanism and working of the gold standard had become very complex during the years immediately preceding its collapse and called for the utmost co-operation on the part of central banks. The post-war conditions, economic, financial, monetary and political, made this co-operation practically impossible and a very severe strain was placed upon the monetary standard which it could not bear and collapsed.

Many of these difficulties were the economic consequences of the great war and of the post-war period. There was a great maladjustment in the economic system because of the war conditions. The inflation of the war time was followed by deflation which failed to bring about a new stable equilibrium. Moreover, after the inflationary experiences of the war period there was a feeling of great anxiety which was responsible for the failure of confidence which was too great a strain upon the

post-war credit system. The restoration of currencies in or about 1925 did not bring about a readjustment of economic conditions and this fact put a very great strain upon the credit system.

INTERNATIONAL INDEBTEDNESS

The increase in international indebtedness was a legacy of the war. It increased very much in a period of falling prices and was one of the foremost causes of the post-war economic instability. This great increase of international indebtedness necessitated the transference of wealth from one country to another on a very large scale and caused disturbing gold movements.

Short-term debts took the place of long-term investments in the post-war period because of geographical changes in the distribution of industries and lack of confidence in long-term investments. Hence funds moved from country to country rapidly. The instability of a number of currencies which was a direct result of the war gave rise to wide speculative movements of short-term capital. Violent price changes discouraged direct investments in productive enterprises of debtor countries. Short-term loans were the results whose burden increased in a period of falling prices.

The flow of capital for foreign investments became more irregular than it was before the war. Violent price changes have discouraged direct lending in productive enterprises of the debtor countries. Therefore, the new loans took the form of short-term investments. The great amount of outstanding short-term credits, while stimulating economic development in the borrowing countries, has been responsible for a lack of stability which has been felt at critical moments. Foreign investments by the United States became an important factor in international financing, but they proved irregular in volume as they were influenced by variations in domestic business conditions there. After the Dawes settlement in 1924 considerable sums were lent to European countries, but after the investment boom of 1928 in the U.S.A., these loans were very much reduced as will be seen by the following table :—

U.S.A. Capital issues for the account of—

| | | European Countries | Canada | Other foreign Countries |
|--------|-------------|-----------------------|--------|-------------------------|
| | | (Millions of Dollars) | | |
| 1927 : | First half | .. | 244 | 154 |
| | Second half | .. | 333 | 78 |
| 1928 : | First half | .. | 449 | 115 |
| | Second half | .. | 148 | 70 |
| 1929 : | First half | .. | 101 | 167 |
| | Second half | .. | 59 | 124 |
| | | | | 204 |
| | | | | 135 |

It will be seen that after the middle of 1928 loans fell very much and this irregularity in international capital movements had very disturbing effects on the settlement of international balances.

OVER-INVESTMENT AND OVER-PRODUCTION

Profound changes in the structure and localization of primary and manufacturing industries in the post-war period also caused disturbances. For instance, the raw produce from far distant countries competed with the European produce and the newly-established cotton industry of the Far East had to face the competition of industrialized Europe. Further, industrial organization became more elaborate and rigid and the success of a few industries tempted many to make investments in them. The result was over-investment and over-production. Thus on the one hand, production increased but demand was transferred to less essential commodities and services and thus became very fitful. As the final report of the Gold Delegation of the Financial Committee of the League of Nations says : "The cartellisation of industry and various forms of price control, pools and control boards of primary products, valorisation schemes and their like, have all tended to render the economic system unduly rigid....We might follow the chain of causation which led, by way of budgetary troubles and high taxation and of higher wages and costs of production in a period of falling prices and capricious demand to the squeezing down of business profits to the point where investment fell off and depression ensued." (Page 20 of the Report.)

Under such circumstances the strain upon the gold standard was unbearable. The second period of post-war inflation ended in a boom, specially in the U.S.A. Towards the end of that boom in 1929, long-term investments particularly in the raw material producing countries fell considerably. Borrowers experienced great difficulty in repaying the loans and mobilized active export surplus to meet their debts. The supply of raw materials increased, stocks accumulated and prices fell. The speculative boom collapsed followed by credit stringency which demoralized the world markets and completely embarrassed the borrowing countries. Hence raw material producing countries went off the gold standard as shown above.

The minority of the Gold Delegation do not believe that the economic maladjustment created by the war was responsible mainly for the fall in prices and the consequent breakdown of the international gold standard. Their contention is that the restoration of the gold standard in 1925 and its successful working up to 1930 "over so wide an area must inevitably have tended to reduce, and not to accentuate, such

disequilibria as remained to be adjusted. For it is in the very nature of the gold standard to compel the countries adhering to it to adjust....their price structure to that of other gold standard countries and so maintain economic equilibrium. That progress could not have been achieved if there had been accumulating in an intensified form all maladjustments which finally caused the rapid rise in the value of gold at the end of that period." (Pages 61 and 62 of the Report quoted above.)

The dominant cause according to them is the maldistribution of the monetary gold reserves which began in the early part of 1929. They point out that the world's total monetary gold stocks between 1929 and June 1931 increased by 8 per cent. while the holdings of France and the U.S.A. increased by 74 per cent. and 19½ per cent. respectively and the stocks of the rest of the world decreased by 23 per cent. This stock, if properly distributed, should have been sufficient to support a volume of credit adequate to maintain the existing level of prices. It was not so and the countries concerned found it impossible to maintain the level of prices prevailing at the end of 1928. To defend their gold resources the central banks applied the normal measure of deflation. Even this failed to re-attract gold to their reserves and gold still flowed into France and the U.S.A. in an unabated manner. The result was pressure upon commodity prices in the gold using countries. This increased competition in world markets and consequently there was a world-wide fall in prices. Hence most of the gold using countries had to abandon the gold standard.

France and the U.S.A. both had favourable balances of trade which up to 1928 had been adjusted by capital exports from them which ceased during and since that year. They placed obstacles in the way of the inflow of commodities with the result that gold only could be sent to them to liquidate indebtedness.

In the second period, *i.e.*, from January 1, 1929, to June 30, 1931, the whole of reparations and war debts were received by them in gold and also the balances which they had accumulated abroad in the earlier period were converted into gold and withdrawn. "It may be said with truth that reparation and war debt payments collected from January 1925 till 1931 (amounting to about 2,262 million dollars) have, over the whole period, been received in gold, with the exception of about 742 million dollars, since the increase in the total gold stocks of these two countries derived from foreign supplies of gold during the period amounted to somewhat more than 1,500 million dollars. Had these two countries not received reparation and war debt payments, they would obviously not have been in a position to draw these sums of gold to themselves." (Page 66, Report of the Gold Delegation.) Up to 1929 the strain

did not prove intolerable because Germany paid reparations by arranging loans with the U.S.A. which were not available afterwards partly because of the development of a stock exchange boom in the United States and partly because Germany had practically exhausted her borrowing power. These payments were not received in goods and services and heavy import duties impeded the entry of German goods into the U.S.A. Hence the breakdown of the gold standard should be regarded as the combined result of the obligations to pay war debts and reparations and the unwillingness of the receiving countries to receive them in goods and services. This accumulation of gold was buried in the vaults of the Central Banks of the U.S.A. and France and did not, therefore, bring about an increase in the supply of means of payment and a rise in internal prices which should have been the automatic effect of the inflow of gold, and this effect in itself would have, according to the classical theory, checked further inflow of gold and brought about the reverse movement.

In fine, the fall in prices has been the fundamental cause of the present depression and this was the result of the obligations to pay reparations and war debts which were unacceptable to the receiving countries in goods and the payment had to be made in gold. Hence the fall of the gold standard.

NECESSITY OF STABILIZATION

The fall in prices has reacted unfavourably on the distribution of income and has affected production also. From the international point of view the most serious aspect of the situation is that the real burden of financial obligations, which were incurred in a period of higher prices has increased. Public finances have been disorganised, unemployment has increased and production has been curtailed.

A rise in price level is, therefore, very necessary to decrease the real burden of debt and other fixed money charges. The question is : Will monetary policy alone readjust the price "which is influenced by many factors of a non-monetary character ?" The majority of the Gold Delegation write that monetary policy expressed through the volume of credit may play a large part in determining the level of prices and that, therefore, excessive contraction should be checked by central banks and a freer use of credit should be encouraged. Economic maladjustments should be corrected though credit should not be expanded prematurely. They regard a relative and not an absolute stability of wholesale commodity prices as the important objective of monetary policy.

The prime objective of a monetary policy should, however, be stability in the general level of wholesale commodity prices. The impediments to international trade produced by the

abandonment of the gold standard in the majority of countries subject the value of gold to the possibility of even wider fluctuations in its purchasing power. The international economic system and the international monetary system are interdependent. The absence of either will curtail production and trade and, therefore, the stability of the monetary and economic systems of the world should be restored at the earliest possible time. This necessitates international agreement and from this point of view the gold standard is the most suitable.

ESSENTIAL CONDITIONS

But if the gold standard is to be restored some essential conditions have to be satisfied. They are :—

- (a) There should be some reasonable settlement of war debts and reparations at an early date.
- (b) Restraints on international trade should be removed as far as possible so that foreign debts can be paid in goods and services.

(c) There must be an assurance that gold will be allowed to move freely and will not be accumulated unduly in any one country without being allowed to exercise its normal influence in raising the price level.

(d) The world must come to some agreement with regard to gold economy. All monetary demands for gold should be deliberately restricted to prevent a great rise in the value of gold.

A non-fulfilment of these conditions will not secure an effective international gold standard and it will not thus be able to provide the necessary security for international trade. If the countries which are still on a gold standard could bring about a rise in prices, the task for paper standard countries will be facilitated and they will be able to return to the gold standard. This step should not be taken without sufficient safeguards for a rational treatment of the gold standard in future in every country.

The monetary gold stocks of the world, according to one of the interim reports of the Gold Delegation, amount to about 12 milliard dollars and of this sum about 8 milliards represent the legal minimum reserves and thus 4 milliards alone are at the free disposal of the Central Banks. The legal minimum reserves are immobilized and lie useless. To increase the active gold reserves of the world all legal stipulations with regard to minimum gold reserves of the Central Banks should be abolished.

The legal regulations of percentage reserves should be abolished and each central bank should be free to see what amount of gold it thinks appropriate to meet the demands

which are likely to arise. "If all nations, at any rate the leading nations, could agree at once to take this step, the active gold reserves of the world would have been trebled and would, therefore, be amply sufficient to support prices at the suggested level."

"If in this way the necessary freedom of movement is given to the Central Banks, it ought no longer to be beyond their power to accomplish a more reasonable distribution of the world's monetary gold supplies, provided, of course, that the present political causes of maldistribution are removed. Thus the way would be paved for the restoration of an international gold standard." (Pages 71, 72 of the Report.)

The Gold Delegation is clearly of the opinion that at the present stage of world economic development "the gold standard remains the best available monetary mechanism." All possible steps should, therefore, be taken for an early restoration of the gold standard. The World Economic Conference of June 1933 failed to solve this thorny question.

CHAPTER XII

Substitutes for the Gold Standard

STABILITY of prices, employment and production is the aim of every monetary scheme. Gold standard had been adopted by the European countries and the U.S.A. by 1870 and it served the purpose up to the outbreak of the war in 1914. But it cannot be maintained that its value in terms of commodities remained unchanged. Prices had fluctuated even during the 19th century, though these fluctuations were by no means violent as to arrest the attention of the banks and other authorities in control of the currency systems on a very large scale. Between 1870 and 1895 gold appreciated in terms of commodities because with the adoption of the gold standard its demand increased very much without any corresponding increase in its supply from fresh mines. This led to a great fall in prices as a result of which many monetary conferences were held to examine the conditions and to suggest remedies. The advocacy of bimetallism was never more vigorous than during this period. After 1890 fresh supplies of gold came from new mines and one of the arguments of the bimetallists was rendered innocuous by an increase in the quantity of gold money. From 1896 onwards till the beginning of the war prices rose by about one-third.

Thus even before the war the gold standard had been found wanting in maintaining the stability of prices. Then came the war bringing in its train inflation and other evils. Prices rose because of the issue of floods of inconvertible paper money which took the place of the gold standard. Some economists abandoned hopes in the gold standard for ensuring stability of prices and favoured its rejection as a monetary standard for the future. Various schemes were put forward and tried ; but were found wanting in achieving this main object. The experience of war time and post-war currency legislation in every country taught this lesson that only a currency based on gold could secure stability of prices and no other system could do so.

These variations in the value of money have led some economists to look for a standard which will work in a better way between the relations of debtors and creditors and one which will vary with variations in economic conditions. One such standard is known as *The Tabular Standard*. It aims at ensuring equity between debtors and creditors. A contract implies a debt, and in businesses there are relationships of giving and receiving money. The disturbances in the value of money imply injustice between debtors and creditors. A

tabular standard replaces the gold standard by a number of representative commodities the value of which would be less likely to fluctuate than the value of one single commodity like gold. To secure internal price steadiness some inconvertible currency would circulate whose value would be stabilized in terms of them and their circulation would be expanded or contracted according to business needs by regulating credit. This task is to be entrusted to a permanent commission appointed by the government. Through these prices the standard is to be maintained. At a future time, the same quantity and quality of goods is to be given to the creditor which has been borrowed at the present time. For instance, a man in 1910 purchases a certain quantity of articles for Rs. 100 and has to repay the debt in 1925. It is to be found out by index numbers what amount of money purchases the same goods in 1925 which were purchased with Rs. 100 in 1910. That amount of money will be paid by the borrower to the lender in 1925. The advantage claimed for this standard is that it will secure equity between debtors and creditors.

Another advantage claimed for it is that it will lessen the hardship and intensity of crises. When prices fall, production decreases and unemployment prevails. Debtors lose very much, for they have to return a greater quantity of real wealth consisting of commodities. According to the Tabular Standard, debtors will get relief because if prices fall, their liabilities will also fall. They will pay a sum of money which can purchase the same quantity of goods which could be purchased at the time of borrowing for the amount of money which they borrowed in a particular year.

This standard is impracticable and undesirable owing to numerous drawbacks inherent in it. The following are the main arguments for its rejection : (1) It involves the use of index numbers which are difficult to be made accurate and are not reliable. After the lapse of time the utility of a commodity which was on the list in a particular year may fall considerably. It is difficult to give proper place to that commodity on the list. Consequently, the preparation of index numbers and the proper weightage of commodities would not be secured. (2) The idea underlying the Tabular Standard is to return the same quantity and quality of goods and of the same utility which were lent. In most of the goods that enter into our consumption the utility of goods depends upon the social esteem in which they are held. These shifting conditions change the value of goods. This standard cannot secure justice between debtors and creditors. (3) It cannot also reduce the number and the hardship of crises. They are caused by so many circumstances over which no particular standard has any control whatsoever.

COMPENSATED DOLLAR SCHEME

Changes in prices always take place under the present system of monetary regime. The value of our monetary unit does not remain stable in terms of its purchasing power at any two given periods of time. The following table shows the trend of prices for about the last 150 years in England and the U.S.A.¹ :—

| Period | Changes in Prices shown by Index Numbers | Name of the Country |
|-----------|---|--------------------------|
| 1789-1809 | .. 85 to 161 (rise). | England. |
| 1809-1849 | .. 161 to 64 (fall). | England. |
| 1849-1873 | .. 74 to 111 (rise). | England. |
| 1873-1896 | .. 100 to 51 (fall). | Gold Standard Countries. |
| 1896-1914 | .. A rise of 50 per cent. in the U.S.A. and of 35 per cent. in England. | |
| 1914-1918 | .. A rise of 106 per cent. in the U.S.A. and of 122 per cent. in England. | |

Prof. Fisher shows that these changes in the purchasing power of money are brought about by money itself and that there is a great influence of money and money substitutes on prices. There are other causes also for changes in prices, but compared with 'money causes' other causes are practically negligible. He has come to this conclusion by the following reasons :—

(1) Price movements vary with monetary systems. Firstly, countries having like monetary standards have similar price movements. Countries having gold standard had similar price movements between 1896-1914, and silver standard countries, e.g., India and China had similar price movements between 1873-1893.² Secondly, countries of dissimilar monetary standards have unlike price movements. Between 1873 and 1896, the price level in gold countries fell by 25 per cent. and rose by 30 per cent. in silver using countries. Thirdly, the degrees of differences in the price levels of countries having different monetary standards correspond to the degree of differences in their monetary standards.

(2) The price movements vary with money supply. In the 16th and the 17th centuries discoveries of precious metals used for money brought about a rise in prices with corresponding rapidity. The war furnished another proof of the influence

¹ Fisher, *Stabilizing the Dollar*, pp. 6 and 7.

² From 1890 to 1914 there was a remarkable similarity among the price movements in the U.S.A., Canada, England, France, Germany, Austria, Italy, Switzerland, Russia, Sweden, Denmark, Holland, Belgium, etc. See Fisher, *Stabilizing the Dollar*, p. 24.

of the supply of money on prices. "In short, the chief causes of the variations in the purchasing power of the dollar are to be found in the dollar itself." (Fisher, *Stabilizing the Dollar*, p. 52.)

The changes in prices are attended with great evils which have been considered in the preceding chapters dealing with inflation and deflation. In short, the main evils are: (a) The cost of living increases, but the changes in individual incomes do not keep pace with the rise in the cost of living to a corresponding extent for every individual. (b) Contracts are upset and injustice is caused to debtors and creditors by falling and rising prices respectively. If it is declared by the Government of India to-day that henceforward the present eight anna piece will be called a rupee, prices will be doubled and the purchasing power of the rupee will be halved. A person who has advanced money to another to-day before this declaration will suffer when he receives back his money which will fall in purchasing power by fifty per cent. by the aforesaid change. (c) Salaries and wages are very slow to be adjusted to changes in prices and people with fixed money incomes lose in times of rising prices, because their same nominal income means a reduction of real income for them as it purchases less of commodities and the reverse is the case in times of falling prices. (d) Changes in prices cause a great social injustice and create an element of uncertainty in businesses resulting in speculation of the worst type. (e) Financial crises are the final results of excessive issues of money or of rising prices and trade cycles and unemployment, mutual suspicion, labour troubles, sabotage, strikes, breakage of machinery and other types of violence are the outcomes of such changes.

In view of these abuses of changes in the purchasing power of money, it is necessary that some scientific remedy should be applied and quack remedies will only accentuate the malady. Prof. Irving Fisher has advocated his stabilizing the Dollar scheme as a true and scientific remedy for preventing changes in prices. He calls the present unstabilized dollar, *i.e.*, the dollar having a fixed weight and, therefore, a varying purchasing power as a barbarous relic because it has not brought about the conditions of civilized life which imply certainty of contracts, freedom from violence and from monetary disturbances and security of life and property. The dollar at present has a fixed weight of gold and roughly one dollar is equal to one-twentieth of an ounce of gold or, to be more accurate, one ounce of gold is equal to 20.67 dollars. It contains 22.23 grains of gold and is nine-tenths fine.³

³ Prof. Fisher writes in his *Compensated Dollar Scheme* on page 82, "Our dollar is now simply a fixed weight of gold, a unit of weight, masquerading as a unit of value. A twentieth of an ounce of gold is no more truly a unit of value or general purchasing power

The plan as advanced by Prof. Fisher for stabilizing the value of the dollar is briefly this :—

(1) Gold coins are not to remain in circulation and only paper notes equal in value to the gold bullion dollar are to form the currency unit. The holder of the gold bullion dollar certificates shall be entitled to get on any date dollars of gold bullion of such weight as may be officially declared to constitute a dollar for that date. The essential thing is that the weight of the gold dollar is to be changed from time to time to keep it stable in terms of purchasing power. The present gold dollar is of a fixed weight, and, therefore, of varying purchasing power. It should vary in weight in order to have a stable purchasing power.

(2) The gold standard is not to be abandoned. The abolition of gold coin would make no important change in the processes by which gold comes into and goes out of circulation. Just as at present the gold miner will take any amount of gold he has to the mint and will get in exchange for it a certain number of paper dollars. The only difference will be that he will not have to deposit the same amount of gold always in order to get one dollar. The unrestricted deposit of gold is the essence of unrestricted coinage. Gold will get into circulation through its representative paper.

Just as at present gold will be taken out of the government vaults by jewellers and gold exporters in exchange for surrendering paper dollars. The difference will be that the same quantity of gold will not be given always in exchange for surrendering paper dollars. In this way gold will flow out or will be converted into the arts and currency from circulation will also be decreased. This amounts to the unrestricted redemption of the gold bullion dollar certificates. Thus free coinage or unrestricted deposit of gold and unrestricted or unlimited redemption of gold bullion certificates will be maintained.

(3) The purchasing power of the gold dollar will be made stable. That is, it will always purchase the same quantity of goods. Therefore, the gold dollar will always be equal in value to an imaginary composite goods dollar consisting of a number of commodities. This composite goods dollar shall at all times be equal to the gold bullion dollar and it will always cost a dollar, because a dollar will be declared to be equal to it. The price of the composite goods dollar will always be kept the same just as the price of gold now is always kept the same. This imaginary composite goods dollar will serve as the

than is a pound of sugar or a dozen eggs. It is almost as absurd to define a unit of value or general purchasing power, in terms of weight, as to define a unit of length in terms of weight, to define a yard stick as....any stick which weighs an ounce."

standard of value and the gold bullion dollar shall always be kept equal to this imaginary goods dollar.

(4) The weight of the gold bullion dollar shall be varied from time to time. Its weight will be varied with reference to the goods dollar. An index number of the articles forming the goods dollar shall be prepared by an Index Number Bureau which will register the prices of these goods in terms of the gold bullion dollar. If the index number shows a rise of one per cent. above par, this means that the purchasing power of gold bullion dollar will have fallen. Therefore the government or the mint will increase the weight of the gold bullion dollar by one per cent. and then it will purchase more. Similarly, if the index number shows a fall of 1 per cent. in the prices of the imaginary goods dollar, it means a rise in the purchasing power of the gold bullion dollar. Its weight will be decreased by one per cent. in order that it may purchase less. In this way by changing the weight of the gold bullion dollar its purchasing power will be kept stable.

But an objection may be raised here as to how the weight of the gold bullion dollar will be changed from time to time and if it is done so, it will mean a great expense and trouble to the mint and the people, which will cause confusion. The answer is simple. No gold coins are to remain in circulation. Only its paper representatives are to circulate. Then it would be possible to vary at will the weight of the gold bullion dollar without any annoyance that would arise from the existence of coins. The government would simply vary the quantity of gold bullion which it would give or take for a paper dollar at any given time.

(5) In order to prevent speculation a small brassage fee will be imposed for the deposit of gold bullion and no change in the gold bullion dollars' weight shall ever exceed the brassage.

The most important part of the scheme is the provision for adjusting the weight of the gold bullion dollar and it is to be done through the help of index numbers. When the value of the dollar falls in terms of goods or when its purchasing power falls, its weight is to be increased and when its value rises, its weight is to be decreased.

The main advantage of the scheme is that the purchasing power of the monetary unit is to be made stable by changing its weight. The plan should start with a price level close to that actually existing before its adoption and no attempt should be made to adopt a certain former level of price where it might be many years back. Businesses would then be free from future shocks. The stability of price level will prevent uncertainty in contracts, avoid confusion, disorder and social

injustice. A second advantage is that it will be effected without abolishing the gold standard and without deviating from the old lines. But Prof. Fisher fears that ignorance and conservatism and the fact that people go more by tradition than by reason will prevent its adoption in practice.

DISADVANTAGES OF THE SCHEME

(1) Its success will depend upon the accuracy of index numbers and indexing being still an art cannot be expected to achieve absolutely accurate conclusions or premises. The disadvantages of index numbers will make it very difficult for the mint to know the real situation. The main difficulty of index numbers is to give proper weight to the commodities specially when their number is very great.

(2) Mr. Keynes objects to the scheme on the ground that it will be late in its operation and attempts will be made, therefore, to correct a change when it has taken place. The change cannot be foreseen and the scheme may be suitable for long period changes in prices, but when changes are abrupt and violent, they should be prevented rather than controlled when they have actually taken place. It will not suit for short period changes in prices which cause great injustice to people.⁴

(3) The unfamiliarity and complexity of the scheme is its great drawback. It is not very simple and easily understandable and it leaves much to the discretion of the officials who may not always act prudently in response to business requirements.

(4) The universal adoption of the scheme will make questions of foreign exchanges a much more complicated and difficult business than it already is.⁵ The scheme would be a cause of much bewilderment and if it were adopted by a large number of nations, it would make questions of exchange more difficult than ever to unravel.

In 1923 in America a Bill was introduced into the House of Representatives and referred to a select committee ; but the scheme was not put into operation.

⁴ "I doubt the wisdom and the practicability of the system so cut and dried. If we wait until a price movement is actually afoot before applying remedial measures, we may be too late. It is not the great rise in prices, but the future rise that has to be counteracted. This method may be adopted to deal with long period trends in the value of gold but not with....short period oscillations of the credit cycle."—Keynes, *A Tract on Monetary Reforms*, p. 187.

⁵ Withers quoted by Messrs. Wadia and Joshi, *Money Market in India*.

CHAPTER XIII

Value of Money

THE value of money means the purchasing power of money in terms of other goods. The purchasing power of money is denoted by the quantity of other goods which a certain quantity of money can command in exchange for itself. In other words, the problem of the value of money is one of the level of prices. The higher the prices of goods, the smaller will be the quantity of other goods which a certain quantity of money will command and the lower the value of money. In the reverse case, if the prices are low, a given quantity of money can command a large quantity of goods and the value of money is correspondingly high. Thus if the value of money is high, prices are low and *vice versa*.

It follows, therefore, that an increase in the quantity of money without any corresponding increase in the quantity of goods to be exchanged for money will lower its value, bringing about a rise in prices. In that case more units of money will be available for purchasing each unit of a commodity. In the alternative case, a sudden decrease in the quantity of money without any corresponding decrease in the quantity of goods to be exchanged will lower prices as less units of money will be available to purchase the same units of goods.

This in brief is the quantity theory of money. It may be stated in this way: "Every change in the quantity of money in circulation produces, other things being equal, a directly proportional change in prices." Of course an increase in the supply of other goods lowers their value; but there is no fixed proportion in which the value of other goods will vary with an increase in their supply. In case of money the proportion in which the change in its value will take place is a fixed one. Double the quantity of money in circulation, other things remaining the same, the value of money will become one-half and prices will become double and in the reverse case, halve the quantity of money, other things being equal, its value will become twice as high as before and prices will be one-half.

The phrase 'other things being equal' is important. (1) It refers to the velocity of circulation of money, i.e., one unit of money may function, let us say, in one hundred transactions and each time that it circulates it does the work of an entirely new unit of money. An increase in the velocity or efficiency of circulation means the same thing as an increase in the quantity of money in circulation and its effect on the value of money is the same as of an increase in its quantity. The use

of credit instruments, where money payments are not only postponed but in most cases altogether avoided, acts in the same way as an increase in the supply or quantity of money in circulation.

(2) Another implication of the phrase 'other things being equal' is that the rate of turnover of goods or the volume of trade should remain the same. An increase in the volume of trade without any change in the effective supply of money will raise the value of money and prices will fall in the same proportion. For in that case, each unit of money will command a greater number of units of goods which means that prices will fall.

(3) The use of credit instruments as money is also included in the phrase 'other things being equal'. Any increase or decrease in the use of credit will mean a corresponding increase or decrease in the effective supply of money and will have the same effect upon the value of money as a corresponding increase in its supply. In modern communities credit plays a very important part in the settlement of transactions. Bank deposits subject to cheques, bills of exchange, promissory notes, stocks, bonds and debentures and other securities pass from hand to hand in settlement of obligations and in discharge of debts. The latter forms of securities, e.g., stocks, shares, debenture bonds of the municipal, provincial and central governments and other public authorities do not circulate very freely as cheques and promissory notes do; but still they do perform exchange operations. All these forms of credit dispense with the use of primary money in many transactions and influence the value of money in the same way as is done by an equal increase in the supply of money.

The system of modern banking involves a great reduction and a consequent economy in the use of commodity money for the settlement of debts. It tends to increase the supply of money and thus prevents a great rise in its value which would take place in the absence of the use of credit.

Properly understood with these qualifications the quantity theory of money is correct. During and since the war various countries suffered the disadvantages of an immense rise in prices brought about by the enormous issues of paper money and by an unprecedented increase in the use of credit. During the last decade or so, a contraction in the issue of paper money and in the use of credit has resulted in the rise of the value of money and in a great fall in prices bringing in its train trade depression and all its concomitant phenomena.

It is also true that in those communities where gold and silver are produced and where precious metals are obtained in very large quantities, prices are high. Moreover, in the past variations in prices have very often been the results of

the discoveries of gold or silver mines or of the exhaustion of the existing gold or silver mines. The monetary history of the 19th century is an ample and eloquent testimony to this effect. After 1870 there was a great fall in prices owing to the lack of new discoveries of gold mines and owing to an enormous increase in the demand for gold for monetary purposes because of the adoption of the gold standard by most of the countries of the world. Various monetary conferences were held to check this depression and proposals for bimetallism were discussed. In the last decade of the 19th century, new discoveries of gold mines helped in raising the price level and bimetallism was shelved probably for a very long time to come if not for ever.

The quantity theory was accepted by the older economists as truly explaining the variations in the value of money ; but its validity has been called into question by many of the modern economists. Prof. Irving Fisher has given an effective reply to all the modern economists who call the validity of the theory into question. He is in fact the most uncompromising propounder of the theory among the modern economists. He explains the quantity theory of money by the question of exchange which is a mathematical statement of the total transactions entered into and performed in a certain community in a given period.

The equation has a money side and a goods side. The money side includes (1) the quantity of money in circulation, (2) the efficiency or velocity of circulation, (3) the quantity of bank deposits subject to cheques, and (4) their velocity of circulation. The goods side includes the total quantity of goods exchanged in a given period multiplied by the prices at which they exchange. The equation of exchange implies that the money side should be equal to the goods side because in each purchase and sale the money and goods exchanged are equivalent. The money side is the total money paid for all the goods purchased and this can be found by multiplying the quantity of money by rapidity of its circulation. The velocity of circulation of money can be known by dividing the total amount of money paid for goods in a given period by the average amount of money in circulation. This is a sort of average of the rates of turnover or money for various persons. The goods side is the quantity of goods exchanged multiplied by their prices.

It is important here to point out that Prof. Fisher includes bank notes, primary and fiduciary money in the term 'money', for they are generally acceptable to people without reference to any characteristic except their general passableness. Bank deposits subject to cheques are not money, but their quantity and velocity of circulation do effect prices. He, however,

maintains that bank deposits bear a fixed ratio to the quantity of money in circulation, firstly, because the banks by custom, law or convenience keep a certain quantity of metallic money in their reserves which bears a fixed proportion to the total quantity of money in circulation. Secondly, the customers to whose credit the deposits exist keep them in a certain proportion to the total cash which they require for day-to-day purposes.

Let us now consider the equation of exchange. The number of sovereigns in circulation in a country is 5,000 and each sovereign changes hands 20 times in a given period. The money side is, therefore, equal to $5,000 \times 20$ sovereigns. The purchasers will not accept goods of a lower value than this in exchange for 100,000 sovereigns and, therefore, the goods side should be equal to 100,000 sovereigns. It may be as follows : 50,000 units of commodity X at half a sovereign per unit and 25,000 units of commodity Y at 3 sovereigns. The equation then is :—

$$\begin{aligned} 5,000 \times 20 &= 50,000 \text{ units of } X \text{ at } \frac{1}{2} \text{ sovereign} = 25,000. \\ &\quad + 25,000 \text{ units of } Y \text{ at } 3 \text{ sovereigns} = 75,000. \end{aligned}$$

The equation on the money side contains (1) the quantity of money in circulation, (2) its velocity of circulation, (3) the quantity of deposits in circulation, and (4) their velocity of circulation ; and on the goods side it includes (1) the quantities of commodities X and Y exchanged multiplied by (2) their prices.

If the quantity of money including deposits is doubled, their velocity of circulation and goods exchanged remaining the same, prices will become double. It is because the money side will become double the former one and the goods side must also change. The equation will become $10,000 \times 20$ sovereigns

$$\begin{aligned} &= 50,000 \text{ units of } X \text{ at } 1 = 50,000 \text{ sovereigns.} \\ &\quad + 25,000 \text{ units of } Y \text{ at } 6 = 150,000 \text{ sovereigns.}^1 \end{aligned}$$

The changes in the velocities of circulation of money and of bank deposits will also affect prices in the same way. But a change in the quantity of goods exchanged will affect prices in the reverse order. If the quantity of goods doubles, other things remaining the same, prices will become one-half, since each unit of money will now command in exchange twice as many units of commodities as formerly. But if there is a change in all these conditions, the level of prices will be the resultant of their influences.

This equation of exchange can be stated in an algebraic form also. Let M stand for the quantity of money in circulation, V for its velocity of circulation, M' for the quantity of bank

¹ It is supposed for the sake of simplicity that the change in the prices of both the commodities is uniform.

deposits subject to cheques and V' for its velocity of circulation. On the goods side let P stand for the average price of any particular commodity X and Q for its total quantity purchased. The equation will be :

$$MV + M'V' = PQ$$

We can show the following by means of the equation.

(1) If M varies, V , M' , V' and Q remaining the same, the money side will vary with M and the goods side must also vary in the same ratio. Therefore, prices or P will vary in the same ratio.

(2) If M' varies, other magnitudes remaining the same, P will vary in the same ratio.

(3) Variations in M' and V' respectively, other things remaining as before, will cause variations in P in the same direction.

(4) If M , V , M' and V' remain as before and Q varies in some ratio, P will vary in the inverse ratio.

Prof. Fisher has further simplified the equation by representing the level of prices of all commodities in one magnitude by P and all the goods exchanged or the volume of trade by T . The equation then becomes

$$MV + M'V' = PT$$

To sum up, the price level varies (1) directly with the quantity of money in circulation, (2) directly with its velocity of circulation, (3) directly with the quantity of deposits, (4) directly with their velocity of circulation, and (5) inversely with the volume of trade. The first of these three relations constitutes 'the quantity theory of money'.

'The quantity of money' means the number of units of money in circulation and it does not refer to their weight. "The quantity theory asserts that (provided the velocity of circulation and the volume of trade are unchanged) if we increase the number of dollars whether by renaming coins or by debasing coins, or by increasing coinage.....prices will be increased in the same proportion." (Fisher, *Purchasing Power of Money*, pages 31 and 32.)²

² "It is the number and not the weight that is essential..... It is a fact which differentiates money from all other goods and explains the peculiar manner in which its purchasing power is related to other goods. Sugar, for instance, has a specific desirability dependent on its quantity in pounds..... The value of sugar depends on its actual quantity. If the quantity of sugar is changed from 1,000,000 pounds to 1,000,000 hundredweights, it does not follow that a hundredweight will have the value previously possessed by a pound. But if money....is changed from 1,000,000 units of one weight to 1,000,000 units of another weight, the value of each unit will remain unchanged." See *Purchasing Power of Money*, by Prof. I. Fisher, p. 32.

Professor Fisher further discusses that in the equation P is the resultant of all— M , V , M' , V' and Q , *i.e.*, that all the other factors are the causes and the level of prices is the result. He takes all these theorems one by one and proves that each of them singly will affect the P 's and not others. (1) He traces the effect of a change in the quantity of money and shows that it will leave other factors undisturbed and will only influence the level of prices. If the quantity of money in circulation is doubled, deposits will also double, because under given conditions of industry and civilization deposits have a fixed relation to the quantity of money in circulation. This, however, will have no influence on their velocities of circulation. The latter will be influenced by the density of population, commercial customs, facilities of transport and other technical conditions. They do not depend on the quantity of money or the price level, changes in which may not produce changes in the velocity of circulation of money. A doubling of prices and of the quantity of money and deposits in circulation will leave their velocities unchanged. Then each person will spend more money for the same goods and will also keep more in hand. But the ratio of money spent on goods to the money in the hands of the people will remain unchanged. If money doubles in quantity, its value will be halved and the only change is that twice as many units as before will be spent and kept in hand by people.

It may be objected to the above reasoning that it assumes that prices will be doubled by doubling the quantity of money in circulation. Let us suppose that doubling the quantity of money and deposits leaves prices as before. In order that the money side should be equal to the goods side, *i.e.*, $MV + M'V' = PT$, then either the velocity of circulation of money and deposits V and V' should be halved or the volume of trade (T) should be doubled. But none of these changes will take place. The former cannot take place, because people will now have double the quantity in their hands or in deposits as surplus money. This will induce them to spend more on goods and everybody will be actuated to do so. This desire will bring the prices up till their level is doubled. Thus if there is no change in the quantity of goods sold, the only possible effect of doubling the quantity of money in circulation will be a doubling of the prices. Doubling the quantity of money will not change the volume of trade, for the stream of business depends on natural resources and the technique of production and not on the quantity of money. The volume of trade is, therefore, independent of the quantity of money.³

³ "An inflation of the currency cannot increase the product of farms and factories nor the speed of freight trains or ships..... The whole machinery of production, transportation and sale is a matter

But it may be said that the technique of production, trade, etc., determine the quantity of goods that will be exchanged for money. Hence the volume of trade may vary according as barter is or is not resorted to. This seems to be a valid objection. But Prof. Fisher rules it out of order, because he maintains that "under normal conditions and in the long run only a negligible fraction of modern trade can be done through barter.....and, therefore, a change in the quantity of money will not appreciably affect the quantities of goods sold for money." (Fisher, *Purchasing Power of Money*, page 156.)⁴ It may then be said that the normal influence of an increase in the quantity of money is that it implies an exactly proportional increase in the general level of prices.

(2) The influence of changes in deposits also produces the same effects on prices as are produced by changes in the quantity of money. Their velocity of circulation will not affect the quantity of money or deposits or the volume of trade, but it will only affect the prices.

(3) The changes in the volume of trade will also bring about changes in the quantity of money and in the velocity of its circulation. An increase in trade will cause an increase in the quantity of money which will prevent a fall in the price level. An increase in trade may increase the velocity of circulation of money. It will imply improved means of transporting goods and money and the latter will increase the velocity of circulation of money. If the change in the volume of trade affects the *per capita* trade, it will affect the velocity of circulation as well. It may mean an increase in *per capita* trade, which will mean an increase in expenditure *per capita* and in a thickly-peopled place, it will imply the greater use of credit bringing about an increase in the velocity of circulation of money. Thus a change in the volume of trade affects other factors of the equation as well in addition to its effect upon prices. But the quantity theory still remains true—that other things remaining the same, prices vary directly with changes in the quantity of money.

of physical capacities and technique, none of which depend on the quantity of money." See *Purchasing Power of Money*, by Prof. I. Fisher, p. 155.

⁴ If it can be shown that a large part of the trade is carried on through barter, the quantity theory of money will be upset. There is little doubt about the fact that in India and even in Western countries the countryfolk exchange commodities directly for commodities to a large extent. The quantity theory of money is valid only on the assumption that commodities are exchanged for money and there is little barter.

SOME OBJECTIONS TO THE QUANTITY THEORY OF MONEY
CONSIDERED

(1) There are some people who think that prices should be regarded as causes and not as effects though we have so far regarded them as effects of other factors in the equation. We have to examine how far this objection is correct. Prof. Fisher proves that except in transitional periods price level is not an independent cause of changes in the other magnitudes of the quantity theory. His reasoning on this account is very convincing and clear.

If prices are doubled in America we have to consider their effects. It is clear that equality between the money side and the goods side must be maintained. It means that either there should be an increase in the quantity of money or in its velocity of circulation or else the volume of trade should diminish. But none of these things is likely to happen.

The quantity of money cannot be increased where prices become high. In fact high prices will induce imports and money will flow out of and not flow into America. More shall not be minted also; because high prices imply a fall in the value of money. No one will take bullion to the mint as he will lose half its value if he gets it manufactured into coins. Money can increase through an increase in the quantity of gold from fresh mines. But high prices do not stimulate mining, on the other hand, they discourage it, for more will be paid for labour and other commodities at high prices and cost of production of gold will increase.

Similarly, high prices will not increase the quantity of deposits, for they maintain a certain ratio to the quantity of money in circulation. Their velocities of circulation also may not increase. The high prices will not diminish the volume of trade. For if all prices including wages are doubled, there is no reason why trade should be reduced. People will not only pay, but will also receive high prices which they will be quite able to pay. Therefore, we can say with confidence that price level is the effect of the other magnitudes of the equation of exchange.

This discussion with regard to prices and the quantity theory of money—the latter being the cause—refers to the same country. “Though it is a fallacy to think that the price level in any community can in the long run affect the money in that community, it is true that the price level in one community may affect the money in another community.” (Fisher, *Purchasing Power of Money*, page 172.)

(2) A second objection to the quantity theory of money is that it is a mere truism. But truisms should not be ignored and when properly understood and explained, they are the most important sources of information.

(3) Some people point out that price level is determined by the law of supply and demand and that, therefore, the equation of exchange is altogether useless and cannot determine the general price level. Prof. Fisher points out that this view is absolutely incorrect. The law of supply and demand determines prices of a particular commodity only, the general price level being determined by the equation of exchange. We cannot depend upon the prices of individual commodities to determine the general price level. The level of the sea cannot be explained by the height of its individual waves ; but on the other hand, in part the position of these waves is to be explained by the level of the sea. In the same way, individual prices cannot determine the general price level, but are themselves determined by it.

When we talk of the price of any commodity considered by itself, we have some idea in our minds of the existing general level of prices. An increase in the supply of the commodity lowers its price and an increase in its demand raises it. When we talk of this we take the general level of prices for granted. The demand for wheat is not only relative to the price of wheat, but also to the general level of prices of other things. The demand for wheat at Rs. 5 a maund at a high level of prices is greater than its demand at Rs. 5 at a low level of prices. If the general level of prices is doubled, the demand for wheat at Rs. 8 per maund will be as great as it was before at Rs. 4 a maund provided incomes and wages also are doubled. A change in the amount of what money will buy is as important as a change in the quantity of a certain commodity. The price of a commodity partly depends upon its quantity and partly upon what a unit of money will buy, *i.e.*, on the general level of prices. Therefore, in saying that the price of a commodity depends upon its supply in relation to its demand, we take the value of money or the general level of prices for granted. There may be an increase in the supply of a particular commodity and still its price may not fall because the prices of other commodities may have fallen much and incomes of people also may have increased or may be as before. Then people may be able to spend more on the particular commodity in question and its price may not fall even with the increased supply. The general level of prices cannot, therefore, be said to be an average of the individual prices of different commodities and the money side of each exchange must not be forgotten. In explaining the general level of prices, help has to be taken of the various magnitudes of the equation of exchange.

(4) It is sometimes objected that the theory cannot give a correct explanation of the changes in the level of prices within a country without taking into consideration the level of prices in other countries. Money tends to flow from countries where prices are high to countries where prices are low,

and this process continues till the same level—giving allowance for its cost of transport and habits of people—is reached.

(5) Prof. Fisher himself, the most uncompromising exponent of the theory, shows that the relation between the quantity of money and the price level does not hold good of transition periods. The words "Transition periods" imply periods when prices rise and fall and in such periods the magnitudes of the equation of exchange try to seek the equilibrium. In such periods the relation between money and deposits is not rigid and prices are not wholly the results of other magnitudes of exchange. All these magnitudes react upon one another in such periods. The proportional effect of changes in the quantity of money on prices is then only the ultimate effect after transition periods are over. But the transition periods are a normal feature of trade and commerce and they are not exceptions. Therefore, the quantity theory of money holds good only under hypothetical and static conditions and not under dynamic conditions which form the rule rather than the exception.

The quantity theory of money has its importance in spite of these objections. The quantity of money in circulation is at any rate one of the most important causes if not the only cause of changes in its value or in the general level of prices. Other causes also are responsible for bringing about changes in the level of prices, but they are of a very shifting character. It is possible to control the level of prices through a control on the quantity of money in circulation. Rising prices can be prevented by lessening the quantity of money in circulation. It can be done by a combination of various methods. The production of gold can be regulated, its quantity in circulation can be controlled, bank and government notes and credit can be lessened. It is possible through a combination of these methods to control the level of prices.

Proposals for preventing a rise in prices through checking or curtailing the expansion of currency are opposed on the ground that this policy would restrict production and create or accentuate unemployment. Such a result may be possible when production and employment are below the maximum under given circumstances. A rise in prices may then stimulate production and reduce unemployment. But after a certain point prices may rise without stimulating production and without encouraging employment through further demands for credit and money. These conditions happened during the Great War. In such cases the volume of money and credits should be curtailed in order to prevent an unnecessarily high rise in prices. The quantity theory of money has, therefore, an important element of truth and is of great significance.

CHAPTER XIV

Foreign Exchanges

THE phrase "foreign exchanges" is used in different senses. It indicates the fluctuations in the relative value of different currencies in the foreign exchange market. We often say, for instance, that if Re. 1 = 1s. 5d., exchange has gone against us. It means that the value of our currency at this ratio has fallen in terms of sterling (par being 1.6 to the rupee). When we say that we buy foreign exchange, the term refers to the currency of the foreign country, which we buy. It may also be used to denote the foreign bill of exchange which is purchased, or to the rate at which it is purchased or to the institutions through which it is purchased.

The necessity of foreign exchanges arises to settle foreign indebtedness. Englishmen, for instance, render certain services to us. We send our goods in English ships and are defended by the British soldiers who have to be paid for rendering these services. We also purchase goods, specially manufactured goods, and have to make payments for them. On the other hand, we export raw materials and food products to England and Englishmen have to make payments to us. Debts are always to be settled in the currency of the creditors for the currency of the country where the debtor resides will not be directly usable by the creditor in his country, if the two reside in two different countries where coinage is different. The creditors, therefore, have to receive money and the debtors have to make payments. The debtors have to purchase bills of exchange payable in the creditors' country, send those bills of exchange to their creditors who can present them for payment to the persons on whom they are drawn. Importers in India have to make payments in sterling and have got to purchase sterling drafts, while exporters in India have to sell sterling drafts.

These bills of exchange are purchased and sold in the foreign exchange market by banks and speculators and thus foreign trade is financed. Foreign exchange has thus a two-fold advantage. It enables the debtor to purchase a bill of exchange drawn in the currency of the country of the creditor by which his obligations can be settled. It thus provides the debtor an opportunity to change his currency for a bill of exchange which will enable his creditor to obtain the money he desires. Secondly, the creditors get an opportunity to sell these bills of exchange or the evidences of indebtedness in exchange for the money of their own country.

Before the war most of the countries were on a gold standard basis and the face value and the bullion value of their currencies were identical. Internally, the currency consisted of gold or of paper and the latter was freely convertible into gold. Further, if it would cost the importer to pay more for a bill of exchange than he would have to pay in getting gold and incurring the expenditure in sending it to his creditor, he preferred the latter method. This implied that gold was freely exportable and importable. This situation of course did not exist during the war and does not exist even now in most countries. The fact that gold was freely available implied that no creditor would part with a bill of exchange in his possession, if he could be able to sell it for less than what he would get by sending for gold. Under such circumstances, he had the alternative to send his bill of exchange to his debtor, ask him to convert it into bullion, get bullion, and reconvert it in his country into coins.

Thus before the war the exchange rates fluctuated within the limits set by the expense of sending metals from one country to another. If this cost remained constant—it could vary also—the limits of the fluctuations were fixed. If this cost increased, the range of fluctuations of the foreign exchange rate increased and if this cost decreased, the range of fluctuations of the exchange rate also decreased. The fluctuations in the rate of exchange before the war were thus confined to what were known as the gold points. They never went beyond them. Within the gold points, they were determined by the balance of indebtedness.

Prior to the war the price of gold in terms of coins was fixed. One pound sterling could buy as much gold as 4.866 dollars could purchase. When the rate at which sterling could be converted into dollars or *vice versa* was such that £1 was equal to 4.866 dollars, the exchange was said to be at par. Thus the par expressed the fact that as much gold was contained in one pound sterling as in 4.866 dollars, *i.e.*, 113 grains of gold was contained in one pound and in 4.866 dollars.

Let us take a simple illustration to see how the exchange rate is determined under such circumstances. Suppose that Americans have exported goods worth £1,000 to England. They will offer sterling bills worth £1,000 to sell. Suppose that goods worth £2,000 have been imported into America from England. The Americans thus have to purchase sterling bills worth £2,000. More sterling bills are in demand and the purchasers will pay more than 4.866 dollars for every pound. An importer will pay 4,885 dollars for a sterling bill of £1,000. If called upon to pay more, he will not submit to this demand for he will get gold, bear the expense of exporting it and will send it to England. Under such circumstances, the foreign

exchange in America will be at a premium, the extent of that premium being limited by all the expenses incurred in transporting specie. The specie exporting point is 4.885 dollars to the £. All the importers in the U.S.A. under such circumstances will have to pay the premium. If on the other hand, the exports from America to England exceed the imports, the reverse situation will appear. More sterling drafts will be offered for sale in America than the importers will purchase. All foreign bills under such circumstances will be sold at a discount. The exporters will get less than 4.866 dollars for every pound sterling. But they have the alternative of getting gold and converting it into dollars. This will secure for them 4.845 dollars for a bill of £1,000. Therefore, if the exchange falls below 4.845 dollars, specie or gold will begin to flow into America. This is known as the specie importing point.

We have taken an extremely simple illustration which is rarely met with in practice and have supposed that the purchasing and selling of foreign bills of exchange is carried on in America and not in England, though actually it is not so. In both the countries the purchases and sales of bills of exchange go on at one and the same time. Moreover, this business is done by the banks and not by the exporters and importers directly. None-the-less, the simple illustration brings out the fundamental truth that when the imports exceed the exports foreign exchange in the country in question will be at a premium and when in the reverse case the exports exceed the imports, it will be at a discount.

Another factor upon which the rate of foreign exchange or of foreign bills of exchange will depend is the intrinsic worth of the bill of exchange. Bankers' bills, *i.e.*, bills drawn by the dealers and bankers on their foreign correspondents will naturally sell at higher rates than most mercantile or trade bills of exchange.

A third factor upon which the rate of exchange will depend is the time for which the bill of exchange has to run. Sight bills will naturally sell at a higher price than time bills of exchange, because in the case of a sight bill of exchange, the payment will be made earlier by the drawee than in the case of a time or a long bill of exchange. Naturally, a purchaser will pay more for a sight bill of exchange than for a time bill of exchange. Foreign sales of merchandise like domestic sales are usually on time and the exporter who has sold his goods is entitled to get payment at the end or expiry of the time for which credit has been given to the purchaser. The exporter draws a bill of exchange payable at the end of the period of credit, but discounts it with his bank. The bank may keep it till maturity if it deals in foreign exchange itself or may send it to its agent in the foreign country or may sell it to a foreign exchange

dealer. The price at which it will sell depends on the length of time for which it has to run, on the prevailing rate of discount and on the future probability of foreign exchanges.

The rate of foreign exchanges does not depend upon the dealings between each separate pair of countries but upon those between a country and all the other countries with which the country in question deals. For example, the exports from the U.S.A. to England may be more than her imports from the latter country, yet foreign exchange in America may be at par if America imports heavily from other countries. The U.S.A. exports more to England than she imports from her. England exports more manufactured goods to Brazil than the value of her imports from the latter country and Brazil exports more coffee to the U.S.A. than the value of her imports from the U.S.A. An American importer of coffee from Brazil cannot easily find an American exporter who has bills to offer on Brazilian merchants, but can find plenty of exporters having bills to offer on London. He buys sterling bills, sends them to his Brazilian creditors who welcome such bills and in turn send them to their English creditors. All these exchange transactions take place through the instrumentality of banking houses. In this way this triangular trade is financed by means of foreign bills of exchange.

We may digress a bit from our main subject and point out that prior to the war, the sterling exchange bills were enormously in demand to settle foreign indebtedness. Her enormous international trade had spread in all parts of the world and the English firms had a well-established repute in dealing in foreign exchanges. It was due to the great industrial prestige of England that sterling bills were widely in demand. Foreign exchange transactions, therefore, were settled through London by bills of exchange drawn on London. The war, however, disturbed this arrangement and America has herself begun to finance her foreign trade. During the war gold was not freely available in England and hence the pound sterling which was equal to gold in pre-war days was no longer regarded so during the war.

In fine, whatever may be the details in the mechanism of foreign exchanges, the exchange rate will depend upon the whole of its international trade. Foreign exchange will be at a premium if imports in aggregate from all countries are greater than exports in aggregate to all countries and at a discount under the reverse circumstances. In the former case specie will flow out, and in the latter case, it will flow in.

In the pre-war days and now also when balance of indebtedness is great, foreign exchanges go against the country in question. Its value in terms of the foreign country's currency falls. But the question is: Will the state of affairs

be permanent ? The answer is that the flow of specie sets in motion forces which ultimately stop that flow. When specie flows out, the value of money rises and prices fall in that country and this stimulates exports. On the other hand, in the country to which specie goes, money in circulation increases, its value falls and prices rise. This stimulates imports into that country. Thus from the former country the original flow of specie is checked.

This process, however, takes a long time for adjustment to be made. Certain devices are undertaken to correct the adverse state of foreign exchanges. Some of such devices followed in the pre-war period were the following :—

The most potential factor is the regulation of the rate of discount by the central banks. A rise in the Bank Rate promotes investment of money in the country in question. Foreigners want to take advantage of the rising rates of interest in that country. If the Bank of England raises the Bank Rate, the effect will be that foreigners will like to send funds to England. This will create a demand for sterling bills of exchange in foreign countries which will send the rate in favour of England. Secondly, if foreigners prior to the rise of the English Bank Rate would have withdrawn their funds from England and this would have made the rate unfavourable to England will not withdraw them now and will like to leave them in England which means that there will not be in England the same demand for foreign bills of exchange which would have been otherwise. Therefore, the exchange rate will not move further against England. Thirdly, higher interest on money makes it more profitable for foreign exchange dealers, who may be preparing for a shipment of specie to other countries, to keep the money at home. Bankers wait until the currents of foreign trade turn and enable the demand for exchange to be met without any shipment of specie. Or they may arrange to send specie from some other country. If the Bank Rate is high in England and low in Germany, Englishmen may buy exchange on Germany and thus may send specie to the U.S.A. from Germany. Further, a rise in the Bank Rate will affect the price of securities inversely to the Bank Rate level. When the Bank Rate rises, securities will fall in price with the natural result that they will become cheaper to purchase. This will create a demand for them and for English money which will raise its value in terms of foreign currency. Finally, the rising cost of borrowed money will prevent the keeping of goods for speculation purposes. This will check the further expansion of industry and cause prices to fall which will stimulate exports and cause money to flow in and improve the exchange rate.

All these influences, however, do not prevent the movement of gold or its ultimate effect on prices, but they only serve

to prevent its movement from taking place at very abrupt levels. When there is a constant balance of payments to be made to a country, gold will begin to flow in till the price level changes. Sometimes this result may be reached without any movement of gold or with a very little movement of it. A country, for instance, may issue paper money and prices may rise without any movement of gold into it. Or it may be a gold mining country. It will export gold in the ordinary course of its international trade. But if its exports of other commodities are very heavy, it may retain this gold and may not have to send it out.

A further point in connection with foreign exchanges is that at one time between two countries the rate of exchange must be the same. But it may not be so owing to ignorance or economic friction, just as in the same market at two different shops there may be two prices for the same commodity. This will, however, set in motion forces which will bring about equilibrium. Under such circumstances, the rate of exchange will be equalized by what are known as *arbitrage operations* which are speculative dealings the effect of which is to send money from a place where its exchange value is low to one where it is high till its value is equalized. This can be made more clear by an imaginary illustration. Take the case of the exchange rates in two places, Paris and London. Suppose £1=25.35 francs in Paris, but in London it is equal to 25.25 francs. Francs, therefore, are cheaper to a holder of pounds in Paris than in London, for in Paris he can get .10 francs more than in London for one pound. But to a holder of francs pounds are cheaper in London than in Paris, because for one pound he has to pay less in London than in Paris. The result will be that pounds will be sold in Paris and a bill of exchange for £1,000 will sell for 25,350 francs in Paris. Francs will be transferred to London and sold for pounds where one thousand pounds will be obtained for only 25,250 francs and a profit of 100 francs will be registered. Again, these pounds will be transferred to Paris, sold there for francs which will be transferred to London and again a profit will be registered. This will go on till the rate of exchange in both places is one and the same. Thus the economic effect of arbitrage operations is to prevent local differences in exchange rates at one and the same time.

There may also be differences in exchange rates in the same place at two different times. They are equalized by very similar speculative dealings known as *straddling operations*. The long rate or the rate of exchange for long or time bills of exchange depends upon the sight rate and always more will be payable for sight bills than for long bills, because in case of the latter bills, the payment of home currency will be immediately

made, but the bill will be payable after a long time. The latter will be determined by the sight rate. Suppose in New York the sight rate is 4.80 dollars to the pound and in London the rate of interest is 4 per cent. Then in New York the rate for 90 d/s bills (sterling) ought to be 4.75 dollars to the £. But suppose the sight rate remaining the same, the long rate in New York is 4.79 dollars to the pound, people will sell long bills of exchange because this will be a paying business. They can get 4.79 dollars for every pound whereas they ought to get 4.75 dollars only according to the short rate. They will invest the funds so obtained in purchasing the short rate. In this way profits will be secured and as more of long bills are offered for sale, this rate must fall and as more of short bills are demanded their rate must rise. Thus the long rate will adjust itself to the short rate. If the long rate again falls and the short rate rises, sight rate will be sold and long rate purchased and a profit again registered. These two sorts of operations tended to steady the rates of exchange between two countries mainly before the war.

The effect of time element upon the rate of exchange may be further considered. It is obvious that the longer the tenor of a bill of exchange the lower will be its price, because cash will be paid at the present time and the buyer will be put in possession of funds after long. In the reverse case, the sooner the purchaser can get money the more he will pay for the bill. That bill will command the highest return which will enable the purchaser to get money immediately. There are what are known as cable or *telegraphic transfers* which put the purchaser in possession of money as soon as the telegram reaches the other centre. Next come *sight bills*. The *short rate* is the rate of exchange at which bills of exchange which have to run for about a week or so can be purchased. *Long rate* is a term used to denote the rate at which 90 d/s bills are offered for sale.

We now come to the method of quotation. Some countries give the method of quotation in terms of their own currency, e.g., New York, Paris, Berlin, etc., and others in terms of foreign currency, e.g., India and England :—

| Place | Method of Quoting | Par of Exchange | Actual Rate |
|----------|----------------------|-----------------|--------------|
| New York | .. Dollars to £. | 4.866 | 3.49½, 3.55 |
| Paris | .. Francs to £. | 25.222 | 55.80, 57.00 |
| Bombay | .. Sterling to rupee | 18d. | 1/7½, 1/7¾ |

The above table shows that the method of quoting is the local currency to the £ in case of New York and Paris. It is thus clear that if a sterling bill is purchased in New York or Paris, the less of local currency is given in exchange for a pound the better from the point of view of the purchaser. Therefore,

in a centre as New York or Paris where the quotation is in home currency the higher rate indicates the higher prices of foreign bills. If the par rate is \$ 4.866 to the £, the higher rate means 4.885 to the £. If at the latter rate a sterling bill worth £ 1,000 is to be purchased more dollars have to be given for every pound or the price of the pound is higher than par rate. In case of a country which quotes in terms of foreign currency, the higher quotation indicates cheaper prices. India quotes in terms of English currency and the par is 1.6 to the rupee. Higher quotation means 1.7 to the rupee. If at the latter quotation a sterling bill of £ 1,000 is to be purchased one rupee will purchase more of English currency at this rate than at par. It is cheaper to purchase a sterling bill at this quotation. In case of a country which gives the method of quotation in terms of foreign currency, the higher quotation, therefore, indicates cheaper rate of foreign bills of exchange.

When a country quotes in terms of foreign currency, the long rate will be above the short rate. Take the case of India where a sterling bill of £ 1,000 is to be purchased. Supposing it is a short bill of exchange and suppose for every rupee 1s. 6d. can be purchased. Thus for a sterling bill of £ 1,000 Rs. 13,333-5-8 will have to be paid. But if a long sterling bill is to be purchased, the same amount of rupees can purchase more than £ 1,000, because the purchaser will be put in possession of funds after a long time, but he will pay rupees immediately. Hence the seller must give more of foreign currency for rupees which he receives immediately. But when the centre quotes in home currency the short rate will be above the long rate. Suppose 4.866 dollars to £ 1 is short rate. A bill of £ 1,000 can be purchased for 4,866 dollars. But if it is a long bill the purchaser will get funds after a long time but will pay dollars immediately. Hence he must pay, say, 4.845 dollars for every pound. The latter is the long rate which is below the short rate.

It can be easily understood now as to what is meant by rising and falling rates of exchange. When a centre quotes the foreign currency, the rate will rise when less of foreign currency can be purchased for the same quantity of home currency. This will be expressed by a falling quotation. If in India the par of exchange is 1.6 to the rupee and suppose the current rate of exchange is 1.5 to the rupee, this means that at the latter rate a rupee can purchase less English currency than at par and, therefore, the rate at which sterling is purchased has risen. If the prevailing rate is 1.7 to the rupee, it means that one rupee can purchase more of English currency than at par and, therefore, this means a fall in the price of English currency. Hence rising quotation in such a case means a fall in rate. If the quotation is in terms of home currency, a rising quotation

means a rising rate, for this shows that more of home currency is to be paid for the same amount of foreign currency than at par ; a falling quotation, on the other hand, means a fall in the price of foreign currency, for less of home currency is to be paid for the same quantity of foreign currency than at par or, in other words, foreign currency can be cheaply purchased.

We now come to favourable and unfavourable rates of exchange. The rate of exchange is unfavourable when the home currency falls in value in relation to the foreign currency, e.g., 1.6=one rupee at par and if the prevailing rate is 1.5=one rupee, the value of the rupee has fallen. Exchange under such circumstances is unfavourable, for more of the home currency is to be given in exchange for the same quantity of foreign currency than formerly. In case of a country giving the quotation in foreign currency, a fall in the quotation implies unfavourable exchange. In case of a centre giving the method of quotation in terms of home currency, a fall in quotation implies a favourable exchange and a rise in quotation denotes that the exchange is unfavourable from the point of view of that centre ; for in the former case less of home currency can purchase the same quantity of foreign currency than formerly and in the latter case more of home currency than formerly is to be given for the same quantity of foreign currency.

An unfavourable or a depreciating exchange stimulates exports and a favourable exchange stimulates imports. If exchange is unfavourable to India, that is, the ratio goes down to 1.5 from 1.6 to the rupee, exports will increase. Because if in England goods sell for 1.5d., that means the Indian exporter will get a rupee whereas if it is at par he will get a rupee if the goods sell for 1.6d. Obviously if the price level remains unchanged in England, unfavourable exchange will be a sort of bounty to exports. But if exchange is favourable, imports will be stimulated and exports checked. For if the exchange rate is prevailing at 1.7 to the rupee, Indians can purchase more goods for 1.7d. than for 1.6d. ; but will have to pay only one rupee. Obviously, a favourable rate stimulates imports.

A depreciated paper currency does not always act as a stimulus to exports and a check to imports. But when paper money depreciates two phenomena appear—a general rise in prices and the specie premium. If the specie premium is higher than the general rise in prices inside the country, exports are stimulated because the exporter by selling in a foreign gold market gets more of the current paper money. This tendency promotes exports still more for their prices rise in the foreign country. If the specie premium is lower than general prices, imports are stimulated because the importer finds it easier to pay for his imports.

We have so far considered the state and determination of foreign exchanges in pre-war days. The above will also hold

good of cases which are normal and when there are no violent disturbances caused by monetary phenomena such as took place during the war of 1914-1919. Serious complications arose during the war in the foreign exchanges owing to different monetary systems in different countries. Exchanges were "dislocated" and speculation of the worst type set in.

The war period was marked by a very great rise in prices brought about by an increasing circulating medium. This increase in the circulating medium was inconvertible paper money in all the European countries and specially in the belligerent ones. Even where this paper was convertible into gold, the melting and exporting of gold were forbidden or were permitted only with the sanction of the governments. The purchasing power of gold also fell throughout the world, because its supply from non-monetary sources increased enormously. Not only this, but the supplies of goods and services fell considerably because of war disturbances and, therefore, the rise in prices was accentuated still more. The main cause of the dislocation of foreign exchanges was this extraordinary issue of inconvertible paper money coupled with the soaring prices brought about by it. Under these circumstances, the traditional methods of regulating foreign exchanges employed by various governments failed utterly to give relief. The following were the methods employed to regulate foreign exchanges and their object was to have a favourable balance of foreign trade in order to come to specie basis. But behind them was lurking an important failure to see that the favourable balance of trade or the excess of exports over imports is itself the consequence of lowered prices which can be achieved by getting rid of the incubus of paper money.

(1) One of these methods was the policy of *exchange pegging* followed by the British Government. The British Government appointed Messrs. Morgan & Co., as their New York agents whose business was to purchase all foreign exchanges or foreign bills of exchange at 4.76 dollars per pound, a price of pounds which was higher than free market conditions would have brought about. Large funds were required to carry on the scheme, because when the price of foreign exchange was kept at a higher level than free market conditions would have allowed, more foreign bills were offered for sale in New York. These funds were obtained by compulsorily acquiring the dollar securities held by British investors and selling them in the market. Or these securities were pledged with the American Government which on their strength allowed credit to the British Government. The difficulty of the situation was this that the policy encouraged imports and consequently the amount of payments also. Hence the further policy of import restrictions was followed. This reduced the strain on the resources of the government. Even then the policy

could not be continued after 1919 and the stoppage of the policy sent the dollar-sterling exchange to \$4.46 : £1 very soon.

(2) Another important device was to fix the price of foreign exchange (foreign bills of exchange or foreign currency) inside the home country at a lower level than could have been brought about by free market conditions. In other words, the value of home currency in terms of foreign currency in the home country was fixed higher than was warranted by free market conditions. The intention was to enable imports to come more cheaply than would have been the case otherwise. Suppose under free market conditions one unit of the currency of country A is equal to one unit of the currency of country B ; but if the government in country A fixes artificially the value as one unit of A=2 units of B, this will increase imports into A country from B ; because 2 units of the currency of country B will purchase more goods in country B than one unit of it. Hence if the value of A's currency is artificially kept high, imports into A will be cheaply brought. But the difficulty will be that more means of payment will be necessary when imports will be stimulated and this was what happened during the war. There was lack of means of payment for increasing imports. The alternative to the currency authority was to raise the price of foreign exchange and admit that its currency was worth really less than its official value. Another alternative was to restrict importation so that the demand for foreign currency might be reduced.

Further, we have seen formerly that if the exchange rate differs at one and the same time in different places, forces will be set in motion to equalize it if it is left to itself. Speculation will set in till it comes to equality in two places. Now fixing the value of the home currency high in terms of the foreign currency inside the country overlooked the fact that in the foreign centre also there was some value of the home currency in terms of the currency of the foreign centre which was fixed by free conditions in the market. That led to arbitrage speculation described previously and increased the difficulties of the currency authority which fixed the value of home currency high inside its own country. There was a great demand for foreign currency for speculative purposes and the government had to differentiate between legitimate and illegitimate demands for foreign currency. Proof was required that commodities had been actually imported and that the demand for foreign currency was genuine. From this it was an easy step to place restrictions upon imports to reduce the demand for foreign currency.

(3) Gold exports were prohibited partly owing to political reasons and partly owing to sentimental and psychological reasons. But this could in no way allay the situation.

(4) *Luxury imports were prohibited* partly with the intention to reduce the demand for foreign currency and partly to make resources available to purchase other more important commodities. This method could not possibly improve the value of the home currency in terms of the foreign currency. It could do so only if the demand for the commodities of the country which had prohibited luxury imports inside the foreign countries was inelastic and further, if the country in question possessed the sole monopoly for those products for which substitutes were not freely available. Then the country might gain, for demand for its commodities would not fall. But such conditions were impossible. It does not, however, mean that stopping the luxury imports was entirely undesirable. It was desirable because it made resources available for purchasing other important commodities or for manufacturing some commodities inside the home country. In the absence of such restrictions these resources would have been used on luxuries.

(5) *The prohibition of capital exports* was another alternative followed to improve the value of the home currency in terms of the foreign currency. It was thought that the prohibition of investment abroad would reduce the demand for foreign currency and thus would prevent a rise in the price of foreign exchange or which comes to the same thing that it would not reduce the value of the home currency in terms of the foreign currency. This meant that the exporters must show to the government that they had received their money within a certain period of time, and must purchase only approved commodities. But suppose they purchased approved commodities; this would not in any way improve matters and would have no effect on foreign exchanges. Or the effect would be the same as when the exporters might invest money in the foreign country. Further, the importers must satisfy the government as to why they were sending money abroad.

(6) *Differential Prices.*—This device meant that higher prices were charged from the foreigners for the goods for which lower prices were charged from home consumers. This device could not improve foreign exchanges for the foreigners must purchase less at high prices unless they had an absolutely inelastic demand which could only be met by the country in question. Further, if the demand for such commodities did not fall, that of others less inelastic in demand would fall. But differential prices were beneficial to make up losses incurred in selling commodities at home at low prices.

(7) *The export of home currency was forbidden.* It was to prevent the imports of certain commodities into a country specially those commodities for which no other kind of payment was available, the idea being to improve the value of the local currency. But the slightest reflection will show that

this device cannot improve foreign exchanges for if more money remains in the country, this will raise the price level and increase imports. The cause of the depreciation of money is not its export, but its over-issue which must be prevented.

All the above and the like devices failed to control and regulate foreign exchanges during the war, because they neglected the main cause of the depreciation of paper money. It is the over-issue of paper money which is responsible for high prices and for increasing imports. These devices were followed because it was thought that the creation of a favourable balance of trade (excess of exports over imports) would improve exchanges. But the balance of trade could not be favourable with the policy of inflation and it was this that ought to have been prevented.

THE THEORY OF PURCHASING POWER PARITY

We now come to the theory of purchasing power parity commonly associated with the name of Gustav Cassel, a Swedish Professor of the University of Stockholm. We saw above that the main cause of variations in exchange rates was not the balance of trade but the level of prices, because the balance of trade itself was determined by the level of prices within and without the country. In other words, the level of prices is the main determinant of the balance of trade. A high price level inside a country as compared with the price level outside will stimulate imports and check exports and make the balance of trade unfavourable which will cause the value of the home currency to depreciate in terms of the value of the foreign currency. A low price level inside the country will produce reverse effects and will make exchanges favourable to the country in question.

It is thus clear that giving allowance for the cost of transport and the taxes on imports and exports, the same articles will cost the same amount in all countries which are in touch with one another. If prices of the same goods are higher in one country than in the other by more than the cost of transport, the goods will be sent from an area of low prices to an area of high prices or from a place where their value in terms of money is low to one where it is high. In the area from which goods come, the value of money will fall, for each unit of money will purchase less than formerly as less goods will remain in that area. In the other area, the value of money will rise because one unit will purchase more than formerly. Therefore, a uniform price level will tend to be established in all these areas. If they all use the same money, money will move from the places where its value is low or which comes to the same thing where prices are high to those where its value is high or prices are low.

It is thus easy to see that the value of money of one of these countries in terms of that of the other will have a definite relation to the amount of the goods it can buy or "the relative value of their moneys will depend upon their relative purchasing power". The rate of exchange between the currencies of these countries will be in the same ratio in which their price levels stand. This is the theory of purchasing power parity. When the currencies of the world were all on a gold basis their relative value depended upon the actual amount of gold metal which the unit of each currency contained and if at any moment it was not so, money used to move quite freely from one place to another. This common measure ceased to be effective under different inconvertible paper systems.

To explain it in another way the theory is this : (1) The purchasing power of an inconvertible paper currency within its own borders depends upon the currency policy of the controlling authority. (2) The purchasing power of an inconvertible paper currency outside the political boundaries of the country depends upon the rate of exchange between the home currency and the foreign currency multiplied by the purchasing power of the foreign currency in the foreign country. Suppose we want to know the purchasing power of the currency of country A in goods in country B. Convert A's currency into B's, supposing one unit of A=2 units of B. Find out how much 2 units of B will purchase. To know this we shall have to multiply the price per unit of a commodity by the number of units in question of B's currency. Thus we shall be able to find out the external value of A's currency. (3) Under conditions of equilibrium the internal and external purchasing powers of the currency of a country must be the same giving allowance for the cost of transport. If that is not so at a particular moment, forces will operate to bring about equilibrium. (4) From the above (1), (2) and (3) it follows that under conditions of equilibrium the ratio of exchange between the home currency and the foreign currency must be equal to the ratio between the purchasing power of the home currency at home and the foreign currency in the foreign country. "This ratio between the respective home purchasing powers of the two currencies is designated their purchasing power parity."

We shall go a bit further into the question and observe that if the price level in one country is higher than the price level in other countries, exports will not be made from that country unless the depreciation of its currency in terms of the foreign currency compensates for the rise in price in that country. Suppose the index number of commodities in country A is 150, exports will be made only if the depreciation of its currency in terms of the foreign currency is 50 per cent.

If its currency depreciates by more than 50 per cent., exports will be stimulated and this will bring about a rise in price still more till the domestic price level is in accordance with the rate of exchange. If the currency of the country depreciates by 20 per cent.; while the rise in price is more than 20 per cent., say 25 per cent., imports will be stimulated. The price level in other countries must rise and this will cause the price level all over the area to come to equality.

The theory, therefore, explains that it is the relative price level and not the balance of trade which ultimately determines the rate of exchange. To say that a country to improve the relative value of its currency must increase exports creates an impossible demand if the internal price level is higher than the external price level. In such cases exports can only take place if the depreciation of its exchange is at least equal to the rise in the internal price level ; otherwise exports will be impossible.

If there are two countries on a gold basis and the unit of currency in each of them contains 100 grains of gold, then one unit of the currency of one will be equal to one unit of that of the other or the par of exchange will be unity. If both of them resort to convertible paper money and the former doubles the quantity of currency in circulation, while the latter quadruples it, the price level in the former will be half of that of the latter. The rate of exchange, therefore, will be that one unit of the former will be equal to two units of the latter in accordance with their relative price levels. The rate of exchange given by a comparison of the price levels of two countries is called the purchasing power parity. If we know, for instance, that the increase in the price levels in two countries is 150 index number of the former and 200 of the latter as compared with the base 100 in a previous period, the rate of exchange will be at par if one unit of the former country's currency is equal to two units of the latter's. If, however, under such conditions of price levels in the two countries, the rate of exchange is such that one unit of the former's currency is equal to $1\frac{1}{2}$ units of the latter's, the former country's currency is under-valued as compared with the purchasing power parity, because one unit of it ought to be equal to two units of the latter; whereas its one unit exchanges only for $1\frac{1}{2}$ units of the latter. The latter's currency under such circumstances is over-valued, for its exchange value is higher than indicated by the relative internal price level. The result will be that exports from the former country will be stimulated into the latter country, because the latter's exchange has appreciated. A depreciating exchange stimulates exports and an appreciating or rising exchange stimulates imports.

The cause of the under-valuation may be due to the fact that the degree of inflation of its currency may be very great

and people may think that the value of their currency will fall still more. Therefore they may speculate and purchase in large quantities the foreign currency which they think is likely to appreciate. It is this expectation of a further fall in its value owing to expected continued inflation which will induce people to export their currency at the prevailing rate and this will cause a further fall in the rate of exchange. Taking the above figures, the following should be the par of exchange :—

| Index No. (rise) in A | in B | Par of Exchange | Actual rate |
|-----------------------|------|----------------------|------------------------------|
| 150 | 200 | 1 unit of A = 2 of B | 1 of A = $1\frac{1}{2}$ of B |

Thus the actual rate of exchange differs from the par of exchange as shown by the purchasing power parity. A's currency is under-valued. It may be because people of A may believe that further inflation of their country's currency will take place and its value will further fall. This will induce them to get possession of the foreign currency in exchange for their own for they may expect the latter's inflation and the consequent fall in the value of its unit will be much less. This will create a greater demand for foreign currency in A than it should and hence the value of B's currency must rise more than warranted by the relative purchasing power. The same reason is responsible for a greater fall in the value of (under-valuation) A's currency than indicated by the purchasing power parity. But we should not misunderstand things and should not regard speculation as the cause of the depreciation of the value of A's currency in relation to B's currency more than denoted by the relative purchasing power of the two currencies in their own countries. This will be tantamount to placing the cart before the horse and mistaking the effect for the cause. For the cause is more and continued inflation which is responsible for speculation and not the other way round. The prevention of further inflation will improve the foreign exchange and will prevent speculation. These conditions till recently were applicable to the currencies of the continental countries and the mark, the lira and the franc were under-valued in terms of the dollar because of the above-mentioned reasons.

On the basis of the present theory, alternative explanations can now be given of the exchange methods followed during the war to improve exchanges. Exchange pegging, for instance, enabled the importing country to keep its prices low and to raise prices in the U.S.A., because at the higher rate of exchange artificially maintained, imports were stimulated into England, caused prices to be lower of the imports and higher of the exports in the U.S.A. than would have been the case otherwise. Thus the purchasing power parity itself moved closer to the pegged rate. Pegging helped American prices to go up to the European level but prevented the latter to some extent from rising up. In the absence of this policy equilibrium would

have been established by a fall in European exchanges and would have wiped out the profits of sale in the high-priced European countries. It must be noted that the purchasing power parity corresponds to the gold parity of the pre-war days with this difference that the purchasing power parity like the other one is not a fixed par. The rate of exchange and the purchasing power par must come to a state of equilibrium but not necessarily by movements in exchange rates only. The purchasing power parity may permanently change if the relative price levels change permanently because of certain causes. "Such a cataclysm as the war....may set up a new equilibrium position. There may, for example, be a change more or less permanent, or at least as prolonged as the reparation payments, in the relative exchange values of Germany's exports and imports respectively, or of those German products and services which enter into international trade and those which cannot. Or again the strengthening of the financial position of the U.S.A. as against Europe.....may have shifted the old equilibrium in a direction favourable to the U.S.A. In such cases it is not correct to assume that the co-efficients of the purchasing power parity, calculated as they generally are by means of the relative variations of index numbers of general purchasing power from their pre-war levels, must ultimately approximate to the actual rates of exchange. Or that internal and external purchasing power must ultimately bear to one another the same relation as in 1913."

If, however, the fluctuations of the purchasing power parity are different from the fluctuations of foreign exchanges, this shows that changes in the prices of the two sets of commodities which respectively do and do not enter into foreign trade are going to take place. Sooner or later the purchasing power parity and the rate of exchange must come together again—either foreign exchanges may come nearer by a movement in it or it may be the other way.

The importance of the purchasing power parity theory is that it regards the internal purchasing power as a more trustworthy indicator of the value of a currency than its market rate of exchange. It is because the internal purchasing power quickly reflects the monetary policy of the country which is the final determinant. Therefore, if exchanges are to be stabilized, price levels must be stabilized first. The stabilization of prices requires two conditions to be performed. Firstly, inflation must be prevented and no more paper money must be issued and secondly, prices must be allowed to find their own level without any hindrance. But if prices are allowed to find their own level, how to deal with the problem of undervaluation of currencies? There are different degrees of

inflation in different countries and if a policy of deflation is followed, the deflation in the countries in which inflation has taken place to a greater extent must be much more which would result in a very sudden and extreme fall in prices. The policy of deflation is not desirable in most cases. Devaluation or stabilizing the internal price levels wherever they are and preventing further changes in them seems to be a better policy. This means that the fluctuations of exchanges are likely to be much greater in the post-war period than in the pre-war times.

EXCHANGE RATES BETWEEN SILVER AND GOLD-USING COUNTRIES

The foreign exchanges between gold countries depend on the equivalent of different gold coins. Thus one English pound contains as much gold as 4.866 American dollars. Therefore, the par rate between them is £ 1 = \$4.866. But all countries are not on a gold basis. Obviously under such circumstances there is a complication in the foreign exchanges. Such a state of affairs is possible when one country is on a gold basis and the other country has a resort to inconvertible paper money, or when one country is on a gold basis and the other on a silver basis as India was up to 1893 and China is to-day. This leads to the phenomena of dislocation of foreign exchanges.

We have already considered the case of countries having resort to inconvertible paper money and shall see now how the rate of exchange is determined between the currencies of two countries—one on a gold and the other on a silver basis. Prior to 1893 the English exporter who had sold goods to an Indian merchant had a bill payable in silver, and even now the English exporters have bills of exchange payable in silver on the Chinese importers. The Indian exporters prior to 1893 had and the Chinese exporters still now have bills of exchange payable in gold on English importers.

Two sets of factors determine the rate of foreign exchange under such circumstances : (1) The balance of indebtedness or the relationship of exports and imports determining the deficiency or excess of bills in two centres required for making payments will be one factor. If there is a greater supply of gold bills in China than there is the demand for them, they will sell at a low price in China. On the other hand, silver bills on the Chinese in England will sell at a high price. This will be the case when exports from China to England exceed the imports into China from the latter country. But should imports into China from England exceed the exports from China into England, the demand for gold bills in China will be greater than their supply and gold bills will be sold at a high price. Conversely, in England there will be a greater supply of silver bills on China than there will be demand for

them and they will be sold at low prices or exchange on China in London will be at a discount.

(2) A second factor which will determine the exchange rate under such cases will be the relative value of gold and silver in terms of one another. If silver falls in value in terms of gold, *i.e.*, gold price of silver falls, gold becomes more valuable in terms of silver. Under such circumstances English exporters' bills on China will become less valuable in England. Englishmen will be able to get less sovereigns or gold coins for their silver bills. Similar was the case with rupee bills on India before 1893. As silver fell in price rupee bills became less valuable to Englishmen, because they could get less sovereigns for such bills of exchange. Under the same conditions, *i.e.*, the falling price of silver the Indian exporter had a more valuable gold bill because by converting it into rupees, he could get more rupees. This state of affairs stimulated exports from India to England and checked imports into India from the latter country. All these phenomena were applicable to Indian conditions before the adoption of the Gold Exchange Standard.

CHAPTER XV

International Trade

THE present is the age of specialization and of division of labour. Individuals, groups of individuals and nations carry on those activities for which they are best fitted by training and natural aptitude. They produce goods in which their labour is most efficacious and get in exchange for them articles produced by others. Everybody stands to gain in this way. This is the case with nations also. Some countries specialize in the production of some commodities and sell those commodities in exchange for others which can be advantageously produced elsewhere. No country of the world is self-sufficient to-day in the production of commodities used by her people. Every country exports and imports a large number of commodities. This interchange of commodities between nations and countries is called international trade. Its extent and magnitude have been continually increasing because of increasing specialization and interdependence. Owing to various inventions and improvements in the arts and methods of production and in transportation facilities, the range of commodities that enter into international trade has increased considerably.

The causes responsible for the exports and imports of different commodities for different countries may now be considered. India exports raw materials and partly manufactured goods and imports mainly manufactured and semi-manufactured goods. Similarly, England's exports to various countries of the world consist of manufactured goods of various types and her imports consist mainly of food products and raw materials. There are certain factors responsible for this state of affairs. In order that a commodity shall be exported from one country to another, it must be somewhat cheaper in the exporting country and it should be so cheap as to bear at least the cost of transport. Thus only those commodities are exported from a country whose prices are lower than in the country to which they are sent. These things are those in which labour is effectively employed. In other words, a country exports those commodities in which it has a comparative advantage and imports those which if produced within its borders, would be high in price. For producing the latter class its labour will be less effective and it has a comparative disadvantage in the production of such commodities.

It is a common notion that high wages and high prices go together and that low wages and low prices are always

consistent. This view is wrong. America exports wheat to England, and England exports cotton and iron and steel goods to India. In America money incomes of the producers are high and wage-earners are also very well remunerated and so is the case with British producers and wage-earners. Thus high wages and low prices can go together provided the productiveness of labour is great. A high wage rate is no obstacle to low prices and to exportation provided labour is very effective in the production of goods concerned. High money wages without effectiveness of labour will mean high prices and will prevent exportation unless the State intervenes.¹ The producers of those commodities in which labour is not effectively employed will find it difficult to meet foreign competition and may even be undersold by foreigners in the former's own country.

India, China and Brazil export raw produce and in these countries money wages are low and labour is also comparatively inefficient. They import manufactured goods produced by efficient and highly paid labour. "They export those things in which their labour is perhaps ineffective, but is less ineffective than it would be in making textiles, hardware and other manufactures. They export those things in the making of which they have a comparative advantage ; that is, those for which, in their own borders, labour is most effective."² Thus incomes and wages may be high or low within a country, those commodities in which its labour is most effective are comparatively cheap and are likely to be exported. The causes of effectiveness of labour may be due to climatic superiority or other natural circumstances. They may arise from skill and aptitude or they may depend upon the availability of best tracts of fertile land, cheap railroad transport, intelligence of the producers, etc.

Thus commodities which are cheaply produced in a country will be exported from it and any cause which makes a commodity cheap acts as an advantage to exports. Exceptionally low wages of a particular kind of labour make a commodity cheap and promote exports. The labour may not be very effective, but exceptionally low wages are conducive to low prices and are a sort of comparative advantage. For instance, in Saxony and Bavaria, there are congested districts where people are willing to work long hours for very low wages and hence toys and some sorts of textile goods are made and exported from these places. Similarly, in England in the chain-

¹ The State may grant bounties or give other concessions to the producers to enable them to export goods to foreign countries. In such cases low effectiveness of labour, high wages and exportation are possible, but this will continue only so long as the State continues granting concessions or in course of time labour should become effective.

² Taussig, *Principles of Economics*, Vol. I, p. 483, 1923 Edition.

making and lace-making industries exceptionally low wages bring about exceptionally low prices. Thus specially low wages and a specially effective labour work in the same direction and promote exports.

It must be mentioned that generally low wages of all classes of labour in a country will not promote the export of commodities produced by low paid labour. There is a common notion among people that commodities produced by low paid labour will lead to under-selling in all goods. In other words, goods made by exceptionally low paid labour will always sell cheaper than goods produced by well paid labour. This idea is wrong and if this would have been true, there should always have been only one-sided trade between countries where in some wages are exceptionally low and in others they are high. In India and Japan wages are lower all round than in America and England and still the former two countries import a large number of commodities from the latter. This fact can be explained by taking an imaginary illustration. Suppose two countries India and England to enter into trade relations suddenly, there having been previously no trade between them. If money wages are lower in India all round and all goods there are cheaper, money has a higher value in India than in England and goods will flow to England and specie to India. Trade will move thus only one way. The flow of specie into India will send up wages and prices will fall in England. This process will continue till equilibrium is established. But that equilibrium will not necessarily be reached at a stage of equal wages in the two countries and this will not lead to equality of prices in both countries. As prices rise in India, it will appear that prices of certain commodities do not move up to the level in England of the same commodities. These are commodities in which Indian labour is most effective or where wages are exceptionally low. These commodities will continue to be exported from India even after a rise in general wages and prices has taken place. Reverse will be the case in England where as a result of the outflow of specie wages and prices will fall. Prices of certain commodities in England will fall below the Indian level and these commodities will be such in which English labour will be very effective or where wages are exceptionally low. These things will be exported to India. "In other words, there can hardly be such a thing as continued underselling in all goods. There will almost certainly be an equalization, or an approach towards equalization, of the value of money in the two countries, and thereafter a development of imports and exports, each country exporting those things in which it has an advantage and importing those in which it has a disadvantage." Of course, no such case as illustrated above has ever appeared and the adjustment has been gradual.

It is clear from the principle of comparative cost or comparative advantage that a country may import even those goods which it can produce more cheaply than the country from which they come. A country may be able to produce two commodities more cheaply than another country, but still one of them may be imported. The reason is that the former country may be able to produce one of the two commodities more cheaply than it can produce the other commodity. The same quantity of labour and capital may give a greater yield of one commodity than that of the other. It will be paying and consequently more economical for a country to produce that commodity in which its advantage is greater and import the other in which its advantage is less. The U.S.A. may produce hemp more cheaply than Russia, yet hemp is imported into America from Russia. The reason is that labour and capital may be more advantageously employed in the production of other commodities and it is to the interest of a country to turn its labour into the most advantageous channels. An able business man may be able to do the regular office routine work more efficiently than his clerk, but none-the-less he delegates that work to a paid secretary. It is because he should confine himself to the task of management, planning and organization in which he has peculiar excellence and which will pay him better. This is known as *the Law of Comparative Advantage or Comparative Cost*.

Very often international trade cannot be explained in this way. Usually there is an absolute advantage on both sides. One country can produce a few commodities more cheaply than another and the former will import those commodities from the latter. Brazil, for instance, can produce coffee more cheaply than America can and India can produce jute more cheaply than other countries. That is why these commodities are exported.

There is a difference between the basis of gain from international trade according as it rests on differences in comparative costs merely or on absolute differences as described above. In the case of absolute differences in advantage, i.e., where one country has an absolute advantage in the production of a commodity over another, exchange under all cases will be to mutual advantage, but in the case of comparative advantage, the existence of trade and the gain from it depend upon the fact that labour cannot freely move from one country to another. This movement of labour is not possible because of the ties of language, nationality, religion, attachment to one's kith and kin and because of difficulties of ignorance, poverty and legislation.

From the above discussion it should not be inferred that a country produces only those commodities which it cannot

import or that whatever articles it exports are supplied exclusively to other countries. The same sort of commodities may be produced at home and imported as well. That is, international trade is competitive and not always complementary. The reasons are: firstly, commodities are produced under conditions of diminishing returns or of varying costs. Wheat is exported from the U.S.A. to England and Germany, but a part of it can be grown in England as cheaply as in America. England and Germany will be at an advantage if they raise wheat from good sources of supply, but if the margin of cultivation is pushed down and wheat is raised from poorer sources, they will not be able to hold their own. As all the supplies cannot be raised from good sources, imports are naturally made. A portion of the supply comes from domestic production, but a large quantity is imported. With manufactured goods the case is somewhat different, because here commonly there are not the same sort of limitations set up by nature to the increase of supply at constant cost. Some division of field is likely to take place here also and between different establishments there are some causes of variation in costs. These forces though not permanent are responsible for variations in cost for considerable periods. In times of rapid changes the period of difference becomes long because before equality of cost is reached between different establishments, there may be an invention somewhere which will be responsible for differences in costs. Some establishments may thus be able to meet foreign competition and others may not. A part of the supply but not all will be imported. But the division of the field between foreign and domestic manufacturers is less common and less likely to persist than such division between foreign and domestic producers in extractive industries.

Secondly, competition is often more apparent than real and costs of transport, tariff barriers and national sentiments may make competition between two countries less unequal and may limit the extent of profitable market available to them.

Further, a lack of knowledge regarding the potential capacity of a nation to produce goods does not exist in any line of production. The knowledge of industrial possibilities grows only slowly and experiments are made to discover the productive capacity of a country for a particular class of goods. Every new industry requires some initiative and energy of some pioneers who are prepared to take risks. These forces take a considerable time to operate, but they tend to secure the ultimate distribution of industries in accordance with the law of comparative costs. The tendency is there, but the forces of change are so strong that a position of equilibrium is seldom reached.

THE GAIN FROM INTERNATIONAL TRADE

The extent of gain to a country from international trade depends upon two factors : firstly, the terms of international exchange, and secondly, the effectiveness of its labour in producing exported commodities. Both these causes are responsible for bringing about high or low money incomes as the case may be and consequently, a greater or a less gain by the purchase of foreign goods.

The prices of goods which enter into international trade are the same in all countries giving allowance for cost of transport. Money incomes are different and the gain from international trade is consequently unequally divided. The English, for instance, buy various classes of goods as cheaply as the Indians and having higher money incomes to purchase both these classes of goods, they benefit more from the trade than Indians do.

The country whose exports are most in demand in other countries and which itself has little demand for the imported goods, that is, for the exports of other countries stands to gain most from international trade ; whereas a country which has the most insistent demand for the exports of other countries gains least from international trade. The extent of the share of the gain from international trade to a country depends upon the marginal utility of imported goods to its people and the marginal utility of its exported goods to foreigners.

This is brought about by specie movements and its distribution and by the equalization of international payments. If the demand for English goods in India increases at current prices—formerly there being a state of equilibrium—specie must flow from the latter country to the former. The result will be that prices and money incomes will fall in India and rise in England. Ultimately there will again be a state of equilibrium. The higher prices of English goods will check exports and the lower Indian prices will stimulate an increase of exports from India. Money incomes will be higher in England than in India and Indians will lose as consumers of English goods because they have low incomes and have to pay high prices for English goods and as consumers of Indian goods Englishmen will gain, because they have high money incomes and the prices of Indian goods fall. Thus an increase in the demand for English goods into India will cause Indians to gain less from the trade between the two countries and will enable Englishmen to gain more.

The appearance of a new article of export in the foreign trade of a country brings specie into it, raises incomes and prices there and reverse conditions prevail in the country to which the new article is exported. The importing country will

gain less by having to pay somewhat higher prices for other commodities of the exporting country and by having lower money incomes to pay for the imports.

The obligations to make other payments as travellers' expenses, interest on accumulated debts, freight charges and the like, have similar effects. The country making payments is likely to be in a worse position with regard to gain from its trade with other countries. The flow of specie from the country in question will lower incomes and prices and, therefore, the advantage from international trade will decrease. The necessity of forcing more exports on foreigners causes the latter to get those commodities on better terms and causes the domestic consumers in the remitting country to get foreign imports on somewhat worse terms.

Thus a country's share in the gain from international trade depends on the play of reciprocal demand. 'The more insistent is the demand for a country's products in other countries, and the less insistent is its own demand for the products of other countries, the greater then is its gain from international trade.'

It is not really the rise or fall of prices, but that of money incomes alone, which is of importance. The changes in the value of money resulting from the forces of international demand are of real and permanent importance with regard to foreign goods only. If prices and incomes in general in a country rise, it only means the use of more counters in exchange. It may disturb the relations between debtors and creditors and rising prices stimulate production. These effects will be temporary. People in the end will be no better off from having higher money incomes if there is a corresponding rise in prices. Domestic prices will rise as much as wages and other incomes because of the inflow of specie. These very conditions, namely, the changes in international trade and the inflow of specie, will affect the prices of imported goods in a different way. The prices of such commodities will fall because of the exports of specie from the country. The higher incomes of the importing country will go further in the purchase of these imported goods and these only. In the reverse case, a fall in prices and incomes due to reverse changes in international trade will affect consumers in their purchases of imported goods only, because the fall in money incomes will be counterbalanced by the fall in their prices. Foreign goods will, however, be dear and the gain from international trade will fall in buying these goods.

A country gains from international trade only if it takes advantage of the relative cheapness of foreign goods. It can secure the advantages of higher money incomes only if cheaper

foreign goods are admitted free of duty, but duties on the imports of foreign goods neutralize that advantage.

A second factor governing the gain from international trade is the effectiveness of the labour of a country in producing commodities which are exported.³ Wheat growers in the U.S.A. and Russia sell their wheat in the markets of the world at the same price and as far as forces of international demand are concerned, the people of both countries gain to the same extent. But the real cost of producing wheat, measured by the amount of labour needed to produce it in both countries is different. It is much less in the U.S.A. than in Russia and money wages being higher in the U.S.A. than in Russia the gain from international trade to the people of the former country is greater. Thus as between any two or more

³ M. Mihaii, Manoilescu, Minister of Trade and Industry in Roumania and formerly a president of the Union of Chambers of Commerce and Industry in that country, has recently written a book on *The Theory of Protection and International Trade*, in which he challenges the theory of the classical economists, namely, Adam Smith, Ricardo and John Stuart Mill, which is that international trade is advantageous to both parties and the author proves that in international trade when the exchange takes place between a manufacturing country and an agricultural country, the former gains most and the latter loses most. His final conclusion given in the preface of the English Edition of his book deserves quotation. He writes, "According to my showing, when an industrial product is exchanged for a primary, and especially an agricultural product, then owing to the superior productivity of industry as compared with agriculture, the product of the labour of an industrial workman is almost always exchanged for the product of the labour of several agricultural workmen.... If in the international exchange an industrial country sends to an agricultural country the produce of the labour of a single workman in order to buy from the latter the produce of the labour of five workmen, is the exchange profitable to both countries? Certainly not. This exchange is unavoidable when the produce imported by the second (agricultural) country, cannot be produced at home, but every time that it can be produced there by the application of the labour of less than five workmen, the exchange ceases to be an advantage to the second (agricultural) country, whose sole advantage would be to give up this exchange and to produce at home. In this case, only the first country (the industrial one) has an advantage, whilst the second (the agricultural country) should avoid such an unprofitable exchange."

What the Roumanian economist means is that the exchange takes place in such a way that the wealth produced by one individual in a manufacturing industry is exchanged for the product of a large number of individuals in primary or extractive industries. In some cases the number of men belonging to the latter category of industries may even exceed 100 and one man thus appropriates the fruit of labour of several men in exchange for the result of his own labour. When this thing happens a large number of people in backward agricultural countries like India apparently produce less wealth than a few persons in an advanced country like England and international trade is advantageous only to one party.

countries competing for the sale of the same article, the extent of their gain from international trade depends upon the relative efficiency of their labour in producing the exported goods.

A country of higher money incomes need not necessarily be one of higher prices also. Commodities that enter into foreign trade tend to be at the same price all the world over under conditions of free trade, giving due allowance for the cost of transportation. Commodities which are meant for domestic consumption vary in prices from country to country in spite of the extension of international trade and competition. Some commodities are too bulky to be exported as bricks, others depend upon habit as articles of household furniture and some are of necessity made on the spot where they are to be used for house accommodation. Personal services as those of domestic servants, lawyers, physicians, actors, etc., are also necessarily rendered on the spot.

These commodities need not be dearer in a country of high money incomes than in a country of low money incomes provided the labour of the former country is very effective in producing them. Thus those domestic commodities in which labour is as effective as in the production of exported goods will be relatively cheap; but those domestic commodities in which there is no such advantage will be dearer to the extent to which labour in their production is less effective. Commodities produced by exceptionally low paid labour will also be relatively cheap.

ITEMS IN FOREIGN TRADE

Foreign trade does not merely consist of the imports and exports of commodities and there are other items of equally great importance which affect the balance of payments because they enter into international trade.

Loans between nations form an important item. They may be contracted by governments or by individuals. It is usually the bankers through whom these dealings take place. If the Americans borrow money in London, they will draw bills on London and if formerly there was a balance of imports and exports, there will be more bills in America for sale on London than the purchasers will require. The price of sterling bills will fall and exchange will fall with the result that specie will flow into America as the American seller of sterling bills will not accept less than a certain amount of dollars. With the help of these credits the Americans might purchase commodities in England and send these bills to their English sellers. Thus commodities might be imported in place of specie. The borrower may use these credits or the purchasing power at home, in the lender's country or in a third country; and in the

first instance the loan will bring about a fall in foreign exchange and a flow of specie into the borrowing country.

If this lending goes on for a long time, a new situation will arise. Interest payments must be regularly made by the borrowing country and it may lead to an increase in exports from the borrowing to the lending country. The lending country which in the beginning had an excess of exports will later on have an excess of imports. Exports from Germany and other countries increased into the U.S.A. and England after the War in payment of interest on debt, etc., and many restrictions on international trade were imposed.

The lending operations in modern times take place through the sale of securities. When governments borrow money, they sell their evidences of debts and individual borrowers sell stocks and bonds. In this way some securities possess an international market and flow freely from country to country and they are largely used to liquidate international balances and prevent the flow of specie.

Remittances to foreign countries for the expenses of tourists and travellers form another class of items affecting international trade. They are also usually settled through the mechanism of foreign bills of exchange and may cause the flow of specie from the country of travellers and tourists. Immigrants may remit money to their relations at home. This will lead to exports from the country where the immigrants are working and living.

Freight charges form another item of the same kind. The foreign trade of India is carried on in foreign ships and remittances have to be made by Indians on freight account. If we had not been able to export goods, specie would have to be paid in exchange.

A country in which specie is produced is in a peculiar position and specially if it produces gold in modern times. It would regularly receive imports in exchange for gold and if its imports from other countries already exceed commodity exports, the specie will remain in the country of production.

The difference between the value of commodity exports and commodity imports of a country is called the *balance of trade*. The balance of trade is said to be *favourable* if the exports in value from a country exceed the imports into it and when its imports exceed its exports, the balance is said to be *unfavourable*. The main reason underlying these terms is that a country gains by exporting a larger money value of goods as they bring specie into it and loses by exporting those which are responsible for sending specie out. Invisible exports include the services rendered to others for which money is

received and invisible imports refer to the services obtained from others for which money has to be paid.

ADVANTAGES AND DISADVANTAGES OF INTERNATIONAL TRADE

The advantages of international trade are similar to those of the localization of industries and of the division of labour. Every country can enjoy goods which cannot be easily produced in it and its inhabitants gain by being able to use a large variety of goods. This increases comfort and happiness. Each country can get a maximum net return for minimum effort and resources because it can carry on the production of those goods only in which it has the greatest advantage. International trade also increases the productive power of the world and leads to a cheapening of prices. The sources of supply and demand increase in number and area and this can lead to greater stability in prices. The interchange of goods promotes the interchange of ideas and economic inter-dependence creates identical interests which may promote peace and good-will.

DISADVANTAGES

1. A country may be forced to exploit her resources to the greater advantage of other nations which may mean a decline in its prosperity.
2. The interests of the present may be kept in view to a great extent at the cost of the interests of the future and though it may be desirable to conserve natural resources for future needs, they may be exploited in the present.
3. Cheap foreign goods may be harmful as drugs and intoxicants are.
4. Foreign competition may ruin a home industry which is very necessary and this may lead to wastage of capital and labour because they cannot be transferred easily to other places.
5. Excessive specialization may lead to congestion of population in mammoth towns which is attended by grave social evils and is also responsible for the deterioration of national health.
6. Excessive specialization and freedom of international trade may be responsible for tying down a nation to hard and toilsome occupations ; whereas others may carry on more refined and skilled crafts. The tropical countries are in the former category and the effects upon the quality of employment may not be wholesome.

CHAPTER XVI

Free Trade and Protection

THE advantages of international trade apply when there are no restrictions on the free movement of commodities from one country to another. As a matter of fact these movements of commodities have not always been free. At present restrictions on trade have been levied in all countries and even England has adopted a definitely protectionist policy.

Ample evidence exists to show the prevalence of various restrictions upon international trade in the past also. From the 14th to the 18th century, the aim of the European Governments was to encourage the inflow of gold and silver or precious metals into their countries. An increase in the stock of precious metals was regarded as being in the best interests of a country. Spain and Portugal acquired the possession of colonies from which they used to import the precious metals and their colonial trade was very advantageous for them. It increased the wealth and political power of these countries and other countries also began to regard the possession of precious metals and of colonies as advantageous. All possible devices calculated to bring precious metals into the country were followed. What is technically known as a policy of mercantilism was followed throughout the Middle Ages.

A favourable balance of trade, *i.e.*, the excess of exports over imports was always sought to be achieved in the European countries in the Middle Ages as this would bring precious metals into a country. The following were some of the devices followed to gain the above-mentioned object:—

1. Export duties were levied on the exports of raw produce to prevent its going abroad. This was with the intention that raw materials would be manufactured at home and that the export of manufactured goods would be of a greater value than exports of raw produce.

2. Imports of manufactured goods were restricted as far as possible by levying import duties. Bounties were given on the manufactures of various commodities calculated to promote exports which would bring money into the country. Imports of raw materials were admitted free of duty.

3. Colonial monopolies were established in the 17th and the 18th centuries and colonial trade was declared as the monopoly

of the mother country from which foreigners were excluded. Colonies were regarded as fit places to grow raw produce for the mother country and to serve as markets for the latter's manufactured commodities.

4. Shipping was encouraged through Navigation Laws. England followed the policy from the 14th to the middle of the 19th century. The coastal trade and the trade between the colonies and the mother country was reserved for the national ships and foreign ships were not allowed to handle such traffic. It was done because the development of the shipping industry would improve the carrying trade and bring money into the country.

5. Fishing was encouraged for this would obviate the difficulty of food for a country to some extent and would prevent the outflow of precious metals which would otherwise have taken place.

6. Population was sought to be encouraged as this would supply labour for industries and soldiers for the armies.

7. Commercial treaties were entered into to obtain commodities produced between the contracting parties on favourable terms. What is known as the most favoured nation clause was inserted in these treaties according to which the contracting parties were to give the same advantage to one another as to any other nation thereafter.

In these and various other ways a policy of protectionism was followed. This, however, created jealousies and national rivalries and was the cause of most of the wars fought during this period. This policy did not succeed in achieving the object which was sought to be achieved through it, and precious metals continued to flow to the East.

There came an era of Free Trade from 1840 to 1870. The advent of the Industrial Revolution had made mass production possible and the various inventions and improvements collectively known by the term Industrial Revolution had been brought about in England not as a result of State guidance but purely by individual enterprise. Adam Smith, the apostle of free trade, therefore, advocated a policy of *laissez faire* or non-intervention on the part of the State in industrial and commercial matters. An individual was regarded as the best judge of himself and his own interests and should, therefore, be allowed freedom of choice. Partly as a result of the teachings of economists like Smith and partly because of the disadvantages of mercantilism of the Middle Ages involving reaction, a policy of free trade was adopted by England in the second quarter of the 19th century. The Corn Laws and Navigation Laws were abolished by about 1850 and the

duties on imports were considerably reduced and whatever duties were left were purely for revenue purposes.

This course was beneficial to England because she required markets for her manufactured goods and raw materials and food products for her industries and industrial population. England, therefore, could not benefit by levying export duties on her manufactured goods or import duties on food products for both courses would have been disadvantageous to her. England had also thought that by adopting free trade herself she would be actuating other countries to let her goods be admitted into their territories without restrictions.

The other countries did not adopt free trade as the English had thought they would do. The most ardent advocates of protection were Frederich List in Germany and H. C. Carey in America. Both were out and out nationalists and thought that the only way to improve their industries was protection.

List pointed out that what was good for England could not be necessarily beneficial for other countries. The policy of free trade for reasons given above was suitable for England but not for Germany whose industries were suffering from English competition. There were possibilities of development of industries in Germany because she was rich in mineral deposits and had a vast territory in which industries could develop. List held that protection should be granted under the following circumstances :—

(1) It could be justified only when it aimed at the industrial education of a nation. In case of a nation like the English whose industrial education was already complete, protection should not be applied. Nor was it to be attempted by countries that had neither the aptitude nor the resources necessary for an industrial career. He was of opinion that nations of the tropical zone were only fit for agriculture and should not attempt at protection, being inherently incapable of achieving industrial development.

(2) It must be shown that the industry was being retarded by foreign competition owing to the early start of the competitor in the industrial sphere. But in the long run the country granting protection must be able to withhold protection after some time and hence in his opinion protection was to be temporary only.

(3) Protection should never be extended to agriculture for agricultural prosperity depends upon industrial prosperity and the development of the latter implies that of the former. Further, an increase in the price of raw materials or of food products would injure manufacturing industries.

He introduced two new ideas into the history of economics. One was that of nationality and the other that of future productivity of a country as contrasted with the present accumulation of wealth. He accused Adam Smith of cosmopolitanism. But according to List between man and full cosmopolitanism must be interpolated the history of nations. Cosmopolitanism was a good idea, but it made national development necessary before it could be achieved. National economic independence was the first thing to be achieved. He distinguished between several stages of economic evolution—the nomadic stage, the pastoral, the agricultural, the agricultural-manufacturing, and the agricultural-manufacturing-commercial stage and even claimed actual historical sequence for this classification. He regarded a nation normal only when it had attained the last stage. To achieve the last stage a vast territory, abundantly rich natural resources and a temperate climate were necessary in his opinion. Germany possessed all these advantages and was fit to achieve the last stage provided her industries were protected against English competition.

Another new idea introduced by him was that of the future productivity of the country. It was not enough for a country to be satisfied with the present advantages of getting more in exchange for home-made products, but these advantages should be maintained for the future also even at the cost of some present advantages. He said, "It is time that experience teaches that the wind bears the seed from one region to another and that thus waste moor lands have been transformed into dense forests, but would it on that account be wise policy for the forester to wait until the wind in the course of ages effects this transformation." Protection is the only method of achieving this object.

It is a pertinent question as to how far modern protectionism owes its inspiration to the ideas of List. It must be mentioned that after 1870 an era of protectionism was renewed and even England tried to follow a policy of reciprocity or fair trade, *i.e.*, levying duties on the imports from countries which did not allow English goods freely into their territories. Other countries, however, from that time onward have followed a policy of protectionism. Can it be said that modern protection owes its origin to List's ideas? It must be pointed out that modern protectionism is to be a temporary policy only and is to be applied in cases where industrial development is being thwarted by foreign competition. To this extent it is inspired by List's ideas. Moreover, it aims at the future industrial progress even though there may be and often is some temporary loss to a country following a protectionist policy. But it must be observed that List favoured protection only

if it increased the industrial education of a nation and secondly, it was not to be applied to agriculture. Judged from these two important criteria, modern protectionism does not owe its origin to the ideas of List. Those countries which adopt protection with a few exceptions are not backward in industrial education as compared with England of List's time. America and Germany and other countries are better in industrial advancement and industrial education than England was in List's time; but still such countries follow a policy of protection. The Safeguarding of Industries Act of 1921 and the famous Mackina duties of 1917 show an element of disguised protectionism in English policy which has now been openly adopted there.

Further all those countries which adopt a protectionist policy in modern times have reached that stage which List called the final stage in economic evolution when no protection according to him was necessary. This also does not show the origin of modern protectionism to List. Finally, he was not in favour of agricultural protection and modern protectionism is applied to agriculture also. This also proves the absence of any connection with or the origin of modern protection to the ideas of List.

PROTECTION Versus FREE TRADE

In the above pages an attempt has been made to give an outline with a brief discussion of the course of international trade in the last few centuries. Now the rival claims of protection and free trade will be considered first, in general and, later, in their application to modern Indian conditions.

The main argument for free trade is simple. It brings gain to both parties which enter into trade relations with one another. Each country devotes itself to the production of commodities for which it is best fitted and thus there is gain by exchange. Free trade thus facilitates territorial division of labour and makes specialization possible to a great extent.

Free trade is advantageous from another point of view as well. It brings greater prosperity to the trading countries as a whole than can be possible if all produce all commodities which they require for their consumption. International free trade makes prices low for it increases the aggregate production, and, therefore, more is available for consumption. It is thus conducive to an increase in economic welfare.

It also promotes unity and harmony among the different nations of the world by making them interdependent upon one another. It makes them realize the interdependence of their

interests and the fact that their economic prosperity is marred or promoted by common causes.

Many of the common arguments for restrictions on trade are fallacious. People are still actuated by old mercantilist notions and regard all exports as good and imports as bad for they think that exports bring money into a country and imports send specie out of a country. They seldom realize that exports are simply the means for paying for imports and they seldom think of the fact that exports are simply means of procuring imports on easier terms than the terms on which the same goods could be got by making them at home. But as already pointed out free trade enables imports to be had more cheaply than by producing them at home.

Some of the popular arguments for protection may now be discussed to see whether they possess any fundamental truths or not. *One of the stock arguments* for protection is that it creates a home market by checking imports and that commodities are produced at home instead of being imported from abroad. In criticism of this argument it can be said that it does not create any additional market but only substitutes a home market for a foreign market which existed formerly. It only implies the substitution or exchange within the country for the exchange between different countries. The real issue is whether commodities can be obtained cheaper at home or by importation. The very fact that commodities could be got cheaper by importation shows that the foreign market is better than the home market.

Another argument and very closely allied with the above one is that protection creates employment and is conducive to greater economic welfare. This pre-supposes that there is a lot of labour and capital always unemployed which can be engaged if protection is applied. Of course unemployed labour is a social evil and unemployed capital a great national waste. It is always good to minimise these social evils. But can protection achieve this object? It seems very improbable because it is very doubtful whether the unemployed labour will easily take to that new industry. There is also no guarantee that it will remain employed because future inventions and improvements may again throw it out of employment. Further, a decrease in imports means a decrease in exports also which is bound to throw men engaged in exporting industries out of employment. There is no reason to suppose, therefore, that protection will increase or create more employment.

Another argument in favour of protection is that it enables wages to be high for employers will get higher prices and will be able to pay higher wages. But it may be said in favour

of free trade that labour can get the same rate of wages if it takes to exporting industries. A protectionist can say that it might lead to over-production if all this labour goes only to the exporting industries. It can, however, be argued in favour of free trade that there cannot be any over-production for prices will fall and sales of those commodities will be great as labour will be very effective there.

The question of wages is one of productivity and the greater the effectiveness of labour, the higher will be the wages. "Protection aims to restrict the geographical division of labour; in doing so, it ordinarily turns industry into less advantageous channels.....Ordinarily it lowers general productivity, general prosperity, general wages." Even if it be supposed that it will raise money wages, it cannot raise real wages which is the real question for labour. It will increase the cost of living specially if the commodities the imports of which are checked by protection happen to be important in the consumption of labour.

People in Western countries are in favour of levying duties on commodities imported from countries like China and India as these commodities are made by low paid labour. They regard free trade advantageous only if it is between countries where the standard of living of labour is the same, but is harmful to a country of high wages when it carries on trade with a country of low wages.

This argument is wrong for if lower wages always give the foreigner an advantage, there could be no exports from countries like the U.S.A. and England. But the goods produced by highly paid labour are really selling cheaper than the same goods produced by low paid labour in countries like India and China. The explanation is quite clear. The effectiveness of labour in the exporting industries is very great and, therefore, they can afford to pay high wages which are compatible with low prices. The law of comparative cost makes it quite clear that in industries where labour is more effective than in others, high wages can be paid and low prices accepted with profits to employers.

The case against protection will be clear by considering the effect of duties in greater details. The effect of an import duty is to raise the price of the commodity in the long run. The price rises by the full amount of the tax provided the commodity is produced under competitive conditions and under constant cost. If a commodity is produced under conditions of increasing cost or diminishing returns, the price rises and demand is checked, production decreases and cost per unit falls. Hence prices rise by less than the amount of the tax. Under conditions of increasing returns price rises

by more than the amount of the tax because a rise in price checks demand and production which increases cost per unit, raising the price by more than the amount of the tax. The producer may not be able to decrease the supply with promptness and for some time the tax may fall on him; but in the long run it will fall on consumers unless the demand for the commodity in question is very elastic.

So long as the commodity continues to be imported, it does not bring any national loss for the loss to the consumer is compensated by the gain to the treasury in the form of revenue. The loss arises when the home producers begin to supply the market for they charge a high price, but the national treasury does not get anything. Hence when the duties are purely for revenue purposes, excise duties are levied on the home production of the commodity. Such was the principle of the excise duty, levied on the production of cotton goods in India till recently.

So far the arguments for free trade have been considered. Now those for protection may be taken into consideration. One important argument is that protection makes the terms of international exchange favourable to the country levying import duties. It helps in decreasing imports unless demand for such commodities is inelastic and in the latter case it will promote home production of such commodities easily. Specie will flow into the country which levies duties. Prices and incomes there will rise and will fall in foreign countries. Exports from that country will be checked and equilibrium will be established ultimately. But then the country levying import duties will gain, because with higher money incomes, people of that country will gain as purchasers of the commodities that still continue to be imported and for the goods of the country in question foreigners will have to pay more. For the disadvantage to consumers in the form of high prices, is to be offset the corresponding gain to the public treasury. Another valid argument in favour of protection is that infant industries in a country deserve to be stimulated. A country may have a vast territory, good and rich natural resources and other possibilities for developing industries. But in the beginning the cost may be high and the industry may not be able to withstand foreign competition at the outset though in the long run it may be able to compete with the foreigners successfully without any artificial stimulus. Under such circumstances, the levying of protection is justifiable subject to the following considerations :—

Firstly, the industry must have vast potentialities of development. Foreign competition must be really felt by it so that it may not be able to develop without protection. Further,

protection should only be temporary and in the long run the industry must not only be able to stand on its own legs without any artificial help, but it must be able to give an advantage or compensation to the consumers in the form of lower prices.

An important obstacle in the way of the removal of protection after some time, say 20 years, is the opposition created by vested interests. But this can be overcome by appointing a permanent body like the Tariff Board in India with a view to examine the claims of industries for protection and to see when the removal of protection is desirable.

A third argument for protection is based on political considerations. Such an illustration is afforded by shipping. Purely economic considerations may permit a country to ship its goods abroad in foreign ships. But there is the question of protection against foreign aggression in times of war. In such circumstances it is risky to depend upon others for protection. After all economic considerations cannot always be separated from political ones and in some cases economics is to be subordinated to politics. It is on this ground that almost all countries have reserved coastal shipping for their nationals and the reservation of coastal traffic has been regarded in all countries as the birth-right of the nationals to which foreigners can be entitled as a matter of concession only and not as a matter of right. This is exactly what we in India want by reserving coastal traffic to our own ships.

Another weighty argument for protection is based on social considerations, though the argument is equally exploited by free traders also. Those in favour of protection point out that the advantages of diversification of industries are many and various. The greater the diversity of industries in a country, the more the possibility of employment; while industries make the people of a country intelligent and adaptable to new occupations. It is pointed out that if only agricultural occupation is pursued, the population becomes dull, unintelligent and unenterprising. As against this, free traders point out the disadvantages of the growth of manufacturing industries as over-crowding in cities, insanitation, decline in health and physique of workmen, loss of touch between workers and employers and greater inequality of incomes and status and dissatisfaction. These are some of the evils referred to by free traders as inherent in large-scale production.

Such are the arguments in favour of free trade and protection. It may be pointed out that recently all the important countries have adopted a policy of protection. It has been due to the growth of nationalistic feelings, to the break-down

of the British school of political economy and to foreign competition which has been specially felt by the continental countries in the case of agricultural produce. Lately, India also has adopted a policy of "discriminating protection". We shall now turn to the discussion of protection from the Indian point of view.

INDIA'S CASE FOR PROTECTION

The fiscal policy of India prior to the war was one of free trade. The war gave impetus to some of the Indian industries as jute, iron and steel etc., by shutting out foreign competition. The Indian Fiscal Commission was appointed in 1920 to consider India's claims for protection. It submitted its report in 1921 and after considering the question in its various aspects recommended the adoption of "discriminate protection". This marked a strong departure from the traditional policy of *laissez faire* followed till then.

The Commission pointed out that there was a very strong feeling in India for protection and that this feeling in many cases was strongly reinforced by India's past when her manufactures were developed to a high pitch of perfection. Indians believed that "this path to riches is barred by an outside power and the suspicion that this outside power is actuated by selfish motives tends to stimulate the belief in the great results that would accrue from the adoption of a policy of protection. All these ideas are further reinforced by the new spirit of national pride, a spirit which in all countries tends to the encouragement of protectionist feeling by demanding.... that the nation should manufacture what the nation uses."

Further, other countries had developed their industries by following a vigorous protectionist policy. In 1879 Germany, in 1881 France, in 1889 Japan, from 1864-65 America and later on the British dominions also—all levied protection to develop their industries. In England also, the Lancashire cotton industry in its infancy was protected by very high import duties. For three-quarters of a century conditions in England have been different from those in India, the former being mainly an exporter of manufactured goods and an importer of food products and raw materials and the latter mainly an importer of manufactured goods and an exporter of raw materials and food-stuffs. The analogy of England did not, therefore, apply to Indian conditions. The former country also has adopted a policy of protection since 1931.

The main argument for free trade is that unfettered trade would turn a country's labour and capital to the most advantageous channels and that the best economic results would be obtained if each country produced those commodities in

which it had the greatest comparative advantages, because by exchanging the products of those industries for articles which it was not able to produce itself cheaply, it would gain most. John Stuart Mill wrote long ago, "The superiority of one country over another in a branch of production often arises only from having begun it sooner. There may be no inherent advantage on one part or disadvantage on the other, but only a present superiority of acquired skill and experience. A country which has this skill and experience yet to acquire may in other respects be better adapted to the production of a commodity than those which were earlier in the field."

Therefore special considerations may justify a policy of protection if the present loss can be more than out-weighed by the future gain. A nation must sacrifice and give up a measure of material prosperity in order to gain culture, skill and powers of united production.

There is of course some burden of protection. The prices of protected commodities rise for they are regulated by the prices of foreign imported commodities. Prices in general also rise for duties check imports which causes an inflow of precious metals raising prices in general. This argument in the special circumstances of India does not apply for India is a country which for long has been regarded as the sink of precious metals where metals come without producing any effect on prices. Another argument for a rise in prices is that the increased cost caused by import duties enters into the cost of production of all articles produced in the country. It increases the cost of living, wages must rise and prices of commodities must go up.

Industrial development requires to be stimulated by protection in the case of India and the immediate loss arising from a check to the exchange of native produce for foreign manufactures may be outweighed by the gain with the development of home manufactures. Protective duties are the crutches, as Colbert called them, which teach the new manufactures to walk.

The Indian Fiscal Commission considered that protection for industries would be beneficial to agriculture for agricultural wages would rise in sympathy with wages in industries and there would be an increase in the demand for agricultural produce. But in a sense it might injure the interests of the agricultural producer for protection would increase the cost of implements, etc., used by him. The rise in the cost of living would be prejudicial to the middle classes with fixed incomes. But the Commission considered all these points and came to the conclusion that if protection was applied with discrimination, the loss would be reduced to the minimum.

The Commission recommended protection with discrimination for the following reasons : (1) One of the disadvantages of protection is the political corruption caused by it. Industrialists spend money to get their own nominees into the legislative bodies which decide matters vitally affecting their interests. In the opinion of the Commission, this danger was not present in India for non-industrial interests were strongly represented. (2) Another disadvantage of protection is that it gives rise to undesirable forms of combinations which can keep the price of the protected commodity above the competitive level. (3) It may also encourage inefficient methods of production specially if care is not taken to see that protection is not granted to unsuitable industries ; they will never reach the stage at which protection should be withdrawn and its burden on consumers will be long continued. (4) Indiscriminate protection would be disadvantageous from the industrial point of view also for the adoption of unnecessarily high duties would enable a large number of concerns to be started. This would create a boom which would be followed by over-production. The development of industries would be pushed beyond the limit of safety and the resulting crisis would shake the confidence so very necessary for building up industries.

For the above reasons, the Commission recommended the adoption of protection with caution. The creation of a Tariff Board was recommended. The business of the Tariff Board was to enquire into the cases of industries applying for protection and to see in the light of the following considerations whether protection was justifiable or not.

The Tariff Board was to be satisfied with regard to the following conditions before recommending protection :—

(1) The industry must be one possessing some natural advantages, *i.e.*, an abundant supply of raw material, cheap power, good labour supply and a large market. Every industry in the world possessed some advantage which was the cause of its success and if the industry claiming protection in India did not possess some such advantage, it could never be able to compete with a foreign industry.

(2) The industry must be one which could not develop without protection or which could not grow as quickly as the interests of the country required without the aid of protection.

(3) The industry must be such that it would be able to face foreign competition without protection after a certain period of time.

The Commission further pointed out that those industries in which the advantages of large-scale production could be

achieved and those which in course of time would supply the whole of the needs of the country should be regarded with a favourable eye by the Tariff Board. It did not follow from this that if an industry could never supply more than a certain proportion of the country's requirements, it was not a fit subject for protection. Protection could be given to it provided it satisfied the three essentials laid down by the Commission.

The Commission laid down that protection as a rule was not to be granted to new industries for in such cases the Tariff Board would have to consider not actual facts but the anticipation of the promoters which would be a task of great difficulty on which judgment could not be framed with success. Moreover, the Commission thought that the financial necessities of the Government of India would ensure the retention of a high duty for the purposes of revenue which would be enough to give protection to the industry at the start. After the industry had developed to some extent and had shown some possibilities of development, it might approach the Tariff Board.

Industries necessary for purposes of national defence for which conditions in India were not unfavourable, *e.g.*, the iron and steel industry, leather, copper, zinc, sulphur, etc., were to be regarded as fit for protection by the Tariff Board. Basic industries or those industries whose products are utilized as raw materials by other industries might be granted protection, but the grant of protection to them was made to rest on considerations of national economics and not on the economics of the particular industry concerned. The Commission recommended the granting of bounties to such industries. Machinery as a rule was to be imported free of duty for protection would mean hardship to the industries using machinery; but if protection was to be granted to machinery, it should be by means of bounties except in the case of industries like jute having monopoly of their supply.

With regard to coal, the Commission thought that its production was suffering from temporary disabilities, the chief of them being the unfavourable railway rates. It being a basic industry, the Commission agreed that it did not become a fit subject for protection and that the case lay in a rapid development of the railway facilities.

The above were the general considerations to be kept in view by the Tariff Board in recommending protection. Thus a very important duty was levied on the Tariff Board to which the duty of recommending the withdrawal of protection was also given when that course became necessary. The Tariff Board was to watch the effect of the duty and to make recommendations from time to time as it thought fit. The Tariff

Board was directed to review periodically the protection given to industries and the period of review was left to its discretion.

Other supplementary measures, as industrial education, compulsory training of apprentices by the firms with whom the Government of India placed orders, railway facilities, anti-dumping legislation, etc., were also recommended to improve industries.

Following the Report of the Fiscal Commission, the Government of India have adopted a policy of protection with discrimination for Indian industries and a Tariff Board has been instituted to advise them with regard to measures of protection. The tariff protection afforded at present is inadequate. The tariffs imposed are not adequately high; while the period of protection in many cases is far too short and there is no adequate provision for prompt action to prevent dumping. Higher tariffs and more substantial protection are in many cases necessary to inspire confidence and induce people to risk their money in industries. The tendency in all progressive countries is to reduce imports and encourage the use of indigenous products, even if foreign goods can be obtained more cheaply.

The Tariff Board has so far examined about twenty-five industries and effective protection has been sanctioned in the case of five or six industries and moderate protection in others. This concession has been adequately availed of to improve industries. The usefulness of the Tariff Board is likely to grow with the growth of the representative character of the Government.

CHAPTER XVII

Imperial Preference

IMPERIAL preference implies the strengthening of the ties of friendship between the countries under the British Empire, and this object is sought to be achieved by economic policy. Under a policy of imperial preference goods coming into an Empire country from another Empire country pay duty at a lower rate than the general rate. This policy, therefore, gives an advantage to the favoured Empire country by stimulating imports from the country paying a lower duty than the general duty.

The question of imperial preference was first introduced in 1897 by Canada when she lowered her duties on British goods. But on account of the existence of certain commercial treaties between Canada and other countries, the same preference had to be extended to those countries. These treaty relations were, however, denounced in 1898. From that time the preference was confined only to Great Britain and those British Colonies which gave to Canada a favourable treatment. The preference was formerly fixed at one-fourth of the duty and later on, in 1900 was raised to one-third.

In 1902 the Colonial Conference passed a resolution to the effect that a policy of imperial preference would be beneficial to the Empire and should accordingly be followed and that this would not imply any lowering of protection which a country might be granting and the Imperial Government was also requested to grant preference on the goods of Empire countries. The preference was purely to be voluntary and did not imply any compulsion. In pursuance to this resolution New Zealand, South Africa (1903) and Australia (1907) extended the policy ; but United Kingdom refused to tax her food-stuffs and raw materials. In 1903, the Government of India was also consulted and declined to follow any such policy for fear of retaliation by other countries and also because India could not gain much from such a policy.

The position up to the end of the War was that India and the United Kingdom refused to have anything to do with such a policy ; but all the self-governing Dominions gave preferences at such rates as they considered advisable to certain products of the United Kingdom, and in some cases to the products of other parts of the Empire.

The War gave a new impetus to the policy of consolidating the Empire and there was produced a general desire on the part of the Empire countries to make the Empire self-sufficient in the production of certain important commodities which are vitally necessary during the period of wars. The Imperial War Conference in 1917 passed a resolution in favour of granting specially favourable treatment and facilities to the produce and manufactures of other parts of the Empire. The Imperial resources were to be developed and the Empire was sought to be made independent of other countries in the matter of food supplies, raw materials and other essential industries. In 1919 the United Kingdom which had so far kept aloof accepted the policy and granted to the whole Empire preferential rates which were usually five-sixths or two-thirds of the full rate on nearly all articles on which import duties were levied. This principle has now been accepted by the Empire countries as a result of the deliberations of the Ottawa Conference held in 1931.

Before discussing the attitude of India and the importance of the question from the Indian point of view, the economic principles underlying imperial preference may be discussed. The meaning of the term has already been explained and it implies the grant of preference on the goods of the Empire countries to promote inter-Imperial relations. The policy embodies the following principles :—

(1) It aims at developing the resources of the Empire and seeks to make the Empire self-sufficient in the matter of the production of food-stuffs, raw materials and other essential goods.

(2) The action is to be purely voluntary and preference can be withdrawn or extended at any time most convenient to any country.

(3) It does not seek to lower the protection to any industry in any country. If a country is giving protection to any industry, and if preference is to be granted to any partner of the Empire in connection with such a commodity, it will take the form of an increase in the duty on the goods of the non-Empire countries.

The policy has a two-fold aim. Firstly, the economic aim is the development of the resources of the Empire to the utmost possible extent. Secondly, it has a political aim also and it is that the Empire is to be made self-sufficient in the production of goods essential during the time of War when the dependence upon foreigners on the supply of such goods will jeopardise the interests of the Empire.

It must be observed that preference is not to be granted

on each and every kind of goods, but only on those goods the production of which is capable of being developed to such an extent that the whole or major portion of the supply can come ultimately from the favoured country. It is to be temporary only and after a certain period of time which is necessary to promote the development of a particular industry in the favoured country, it is to be withdrawn.

It resembles protection for in both cases the consumer is invited to suffer a temporary loss. In both cases, it is expected that when the policy succeeds, the loss will terminate and the consumer may gain in the form of low prices which must prevail when the success of the industry in question is ensured. Further, both protection and imperial preference are to be granted only to those industries which are likely to succeed in the long run and for which chances are very favourable. It differs from protection inasmuch as the advantage for which the consumer is asked to suffer a temporary loss will accrue to the industries of the foreign country to which preference is given whereas in case of protection, the advantage will accrue to the industries of the consumer's country.

The effects of imperial preference are two-fold. One is that it imposes a temporary burden on the consumer. So long as a large portion of the supply comes from the countries to which preference is not granted, the price of the commodity will be regulated by the higher duty. The consumer will have to pay the higher price on the whole supply and the difference between the two rates of duty will be the advantage to the country to which preference is granted. But when the country receiving preference begins to supply the whole market, the price of the commodity will be regulated by the lower rate and the consumer will benefit. The question of the loss to the consumer will depend upon the relative importance of the sources of supply. If a large part comes from the favoured country, the burden will be small; but if a large part comes from the non-favoured countries, the burden will be large.

It must not be assumed from the above that only in the event of a loss to the consumer, the favoured country will stand to gain. The favoured country can gain even when the consumer gains. It is because the favoured country may after some time capture the whole market driving the non-favoured manufacturers out of the field. The price to the consumer will be governed by the lower duty and the favoured manufacturers will find that the price will fall to the true competitive level. The favoured country will have captured the whole market and will have high profits. Thus the gain of the consumer can be co-existent with the gain to the favoured country.

It has got a revenue aspect as well. If the preference is a reduction from the real rate, it is clear that the country granting preference is sacrificing revenue for it will get less income from the duties. It may be said that if the preference is given by raising rates on the goods of the non-favoured countries, the country granting preference does not lose revenue. On the other hand, it gains more revenue by raising the duty against non-favoured countries. But the thing is not so simple as that. The best tax is that which gets as much revenue for the treasury as is the burden imposed upon the consumers. In this case, the consumers pay more than the receipts of the treasury from this source. The price to the consumer is governed by the higher duty and the State does not secure as revenue the full amount taken from the pocket of the consumer. Economically, therefore, such a tax is unsound. It may then be said that the Government loses revenue—not actual revenue, but relating to the amount which it should receive in view of the burden placed upon the consumer.

There is one possible advantage to the country granting preference. If imports are attracted from a particular country, exports must increase to that country. It is some indirect advantage to the country granting preference provided its exports are competing with the goods of other countries in the market of the favoured country.

So far we have discussed the economic effects of imperial preference in general. We shall now view them from the Indian standpoint. India cannot gain much from a policy of imperial preference because her exports are mainly raw materials and food products a large portion of which goes to non-Empire countries. The imports into India are mainly manufactured commodities coming from the Empire as well as the non-Empire countries. The advantage of preference is more in the case of manufactured goods than in the case of raw materials. Raw materials are generally admitted free in foreign countries and they find their markets ready-made.¹ It is mainly in regard to manufactured goods that competition is most felt. India, therefore, cannot gain much though it can give much to other countries by imperial preference.

Another objection to imperial preference from the Indian point of view is that India's exports are to non-Empire

¹ This situation is to a great extent altered now. Competition for the sale of raw materials in foreign countries has increased to a great extent on account of improvements in the technique of the agricultural industry in various countries of the world. Indian raw produce in foreign markets has to meet the competition of other suppliers as well.

countries mostly and imperial preference will induce the foreigners to adopt retaliatory measures against Indian goods. Though this fear is exaggerated for raw materials find markets easily, yet there is something in it and foreigners can take retaliatory measures to some extent.

Another fear is that it may decrease protection granted to Indian industries. But it must be said that it need not diminish protection; for theoretically under no circumstances should preference be allowed to diminish protection which an industry requires.²

It is also pointed out that it will impose a burden on the Indian consumer for the sake of the gain to the Britishers. That it would do so is not untrue. But India also may receive preference on some goods and in estimating the economic loss to India, consideration of this fact also has to be taken in view. The majority of the Fiscal Commission pointed out "that India at present enjoys the protection of the British Navy in return for a merely nominal contribution" and that this is a compensating advantage. But the minority of the Commission in their Minute of Dissent differ very strongly on this point from their colleagues. They write, "We regret that our colleagues should have pleaded for the imperial preference on the ground amongst others of maintaining the British Navy.

² Mr. G. D. Birla, in a special article which was published in the *Leader* of Wednesday, September 7, 1932, wrote:—

"There can be no two opinions that a policy of protection puts a certain amount of burden on the consumer. It is done in order that eventually not only the burden is removed but the consumer is benefited by getting his requirements at a cheaper price than the price of imported articles. Under an effective policy of protection it is thus expected that the industry will develop and expand to such a high pitch that in course of time it will begin to produce more than the total requirements of the country and, consequently, on account of internal competition the prices of indigenous products would go below the price of imported goods and thus make the tariff wall more or less inoperative. The consumer, therefore, is expected to make this sacrifice for his own benefit and the sacrifice is thus treated as a sort of investment. But when inadequate protection is granted, although the consumer suffers, yet the industry does not expand to its fullest extent enabling it to meet the full requirements of home consumption, and reducing its cost of production. The result is that the consumer has to pay permanently a high price for his requirements. This is exactly what will happen under a policy of preference, which in other words means inadequate and ineffective protection. Under this policy while the consumer will have to make full sacrifice there will be no compensating advantage either to the industry or to him. What is sought to be done is to grant a virtual protection to the foreign manufacturer at the cost of the Indian tax-payer and the consumer. From this point of view again the present agreement stands condemned."

We feel that the question of the naval defence of the Empire stands on an entirely different footing and ought not to have been brought forward in this connection..... We will content ourselves by remarking that the economic prosperity which we anticipate as the result of extensive industrialization will, in course of time, enable India to maintain in Indian waters a navy sufficient for the defence of India, officered and manned by Indians."

Another fear is that if India accepted the principle of imperial preference, it is possible that her fiscal policy may be directed not in her own interests but in the interests of other parts of the Empire and she would be dictated regardless of her own interests and wishes. But the majority of the Fiscal Commission are of the opinion that this is a misunderstanding of the principles underlying imperial preference. It does not amount to a unified policy for the whole Empire dictated by binding resolution, passed at periodical Imperial Conferences. But it may be pointed out that the policy followed by the Dominions may have been directed by the Dominions themselves and not by binding resolutions ; yet the case of India is different. She is not a self-governing Dominion and the principle of imperial preference may be utilized against India to interfere with her fiscal autonomy. The Commission quote the recommendations made by the Joint Select Committee on the Government of India Bill which are as follows :—

"Whatever be the right fiscal policy for India....it is quite clear that she should have the same liberty to consider her interests as Great Britain, Australia, New Zealand, Canada, and South Africa..... The Secretary of State should, as far as possible, avoid interference on this subject when the Government of India and its legislature are in agreement and....his intervention....should be limited to safeguarding the international obligations of the Empire or any fiscal arrangements within the Empire to which His Majesty's Government is a party."

The above principle was accepted by the Secretary of State. But the words "any fiscal arrangements within the Empire to which His Majesty's Government is a party" may raise some doubt and may suggest that a policy like that of imperial preference may be forced on India. The Commission, nevertheless, think that the way in which the policy has worked does not show that it can be forced. The Commission, however, lay down that no preference should be granted on any commodity without the explicit approval of the Indian Legislature. The Commission wrote that the question of imperial preference should be considered not merely from the narrow economic and selfish point of view but also from a wider Imperial

point of view and that India should not remain aloof from such a policy ; but that the decision must rest with the Indian Legislature.

As for granting preference on the goods of the Dominions, the Commission pointed out that India might grant preference only in case Indian goods got preference in the markets of the Dominions. But the minority differed from the majority on both these points and wrote as follows :—

(I) "We are in favour of the principle of imperial preference on the distinct condition that India should in this matter be put on the same footing of freedom as is enjoyed by the self-governing Dominions, and that the non-official members of the Assembly should be given power by legislation or other equally effective means to initiate, grant, vary and withdraw preference as may be necessary in the interests of India in all its aspects.

(II) That the conditions precedent to any agreement with a British Dominion in trade matters on the basis of reciprocity should be the recognition of the right of the Indian people to a status of complete equality and the repeal of all anti-Asiatic Laws so far as they apply to the people of India."

"No agreements based even on reciprocity in trade matters should be entered into with any dominion which has on its statute book any anti-Asiatic legislation applying to the Indian people.... To the Indian people their self-respect is of far more importance than any economic advantage which any Dominion may choose to confer by means of any preferential treatment. We may confidently state that the people of India would much prefer the withdrawal of such preference as they would not care to be economically indebted to any Dominion which does not treat them as equal members of the British Empire having equal rights of citizenship."

It must be said that Indian commercial magnates do not want imperial preference for India has to lose much by pursuing the policy and the gain to her is small. If India is given a status like the other self-governing Dominions of the Empire, she may consider the policy ; but till then it is better for India to remain aloof from any such policy.³

³ As a result of the deliberations of the Ottawa Conference, the Ottawa Agreement was endorsed by the Indian Legislature and became Law. The main features underlying the agreement between India and Great Britain are as follows :—

(1) The United Kingdom will continue to give free entry to all Indian goods within the general scope of duty of 10 per cent. *ad valorem* which was imposed by the United Kingdom as a result of the Import Duties Act of 1932. The principal commodities affected are Indian cotton manufactures, coir manufactures, Indian carpets

THE WORKING OF THE OTTAWA AGREEMENT

The Ottawa Agreement has been in operation for about two years and its effects on Indian trade may now be examined. Dr. Meek, Director-General of Commercial Intelligence with

and rugs, jute manufactures, tanned hides and tanned skins, non-essential vegetable oils, sandalwood oil, oil-seeds, cake and meal rice, groundnuts, coffee, tobacco, tea, spices, castor seed, teak and other hard woods, pig iron, lead, magnesite, Indian granite and magnesium, chloride, shellac, raw jute, myrobalans, broken rice and mica.

(2) As a result of discussions in London, Indian pig iron and semi-finished steel may be admitted free of duty in England.

(3) Contingent on the arrangements arrived at with the other parts of the British Commonwealth of Nations, the existing preferences will be retained on barley, peas, beans, pulses, millets, manures, goat skins and asbestos.

(4) With regard to the cotton trade, the agreement provides that the Indian delegation have discussed with His Majesty's Government in the United Kingdom and the representatives of the United Kingdom cotton trade means by which a greater use of Indian cotton in the United Kingdom might be stimulated. Thus preference upon cotton is problematical and no certainty has been shown in connection with it.

(5) India is to grant $7\frac{1}{2}$ per cent. preference on certain motor vehicles and on other articles the rate of preference will be 10 per cent. which may be given either by increase of duties on foreign goods or by reduction of duty on United Kingdom goods or by a combination of both the methods.

The 10 per cent. preference extends to the following classes of goods: Buildings and engineering materials, chemicals, drugs and medicines, earthenware and porcelain, furniture and cabinet wares, hardware, electrical, musical, photographic, scientific, surgical, wireless and miscellaneous instruments, leather manufactures, aluminium, copper, lead, German silver, zinc, brass and silver alloys and their manufactures, paint and painter's materials, paper and stationery, rubber tyres and other manufactures of rubber, vehicles not mechanically propelled and cycles. In these cases preference is subject to certain reservations and does not extend (a) to commodities to which protection is applicable, (b) to those duty-free at present, (c) to those on which on grounds of national policy a lower rate of duty has been imposed. The 10 per cent. duty will also extend to asbestos manufactures, boots and shoes of leather, brushes, metal buttons, cordage and rope, cork manufactures, cutlery, glue, leather cloth and artificial leather, smoker's requisites, toilet soap, toilet requisites, toys and requisites for games, umbrellas and umbrella fittings, filled cartridges and cartridge cases, oil cloth and floor cloth, engine boiler packing, perfumed spirit, articles of food and drink, ale and beer, cocoa and chocolate, confectionery, tinned or canned fish, canned or bottled fruit, provisions, condensed and preserved milk, oils, fish oil, synthetic essential oil, natural essential oil, mineral lubricating oils and vegetable non-essential oils and machinery paying 25 per cent. duty.

Besides these articles, the question of granting preference on cotton manufactures and silk goods will be decided after the Tariff Board has made its recommendations, but a 10 per cent. preference is already

the Government of India, was specially directed by the Government to examine carefully the trade figures of India and he issued an elaborate report on the working of the Agreement. A special Committee of the Central Legislature was appointed to go into the report of Dr. Meek and submit its views to both Houses. The Report of this Committee together with the Minutes of Dissent by a few members was published in due course.

Turning to the conclusions of Dr. Meek, based as they are on the latest commercial statistics of the country, the following conclusions are worth being emphasized. On the export side, wheat did not get any stimulus from the preference of two shillings which it enjoyed; while rice exports into the British market increased from 30,000 tons in 1931-32 to 90,000 tons in 1933-34. Vegetable oils showed an increase of 68,000 gallons over the figures for 1931-32 as a result of the ten per cent. preference. Groundnut oil showed an increase of 300 gallons from 3,700 in 1932-33 to 4,000 in 1933-34. According to Dr. Meek, these figures represent 95 per cent. of the British market, compared to the 5 per cent. which Indian groundnut oil represented in 1931-32. Argentine linseed seems to have been ousted by Indian linseed from the British market in view of the fact that Indian exports of this commodity to the British market were only 14,000 tons in 1932-33; whereas

promised. Steel goods are already getting preference on United Kingdom goods. An additional preference has already been granted to United Kingdom manufacturers of cotton as a result of the acceptance of the recommendations of the Tariff Board by the Government. Both these articles should be added to the list.

It is said that the extension of India's trade and letting protection unimpaired have been the fundamental principles kept in view by the Indian delegation in arriving at the agreement.

Arrangements have been made for exchange of preferences with colonies and protectorates which will, generally speaking, extend to India the full benefits of their preferential tariffs when these exchanges become effective. It will mean preferences to India on cotton manufactures, tea, coffee, oil-seeds, vegetable oils, paraffin, wax, carpets and rugs and India is to grant preference to them on guns, resins, oil-seeds, vegetable and essential oils, unground spices, cocoanut and cocoanut products, fish, fruits and vegetables, sago and tapioca rum and unmanufactured tobacco.

With regard to the Dominions, conversations have taken place between the Indian delegation and the Dominion delegates on the subject of possible tariff agreements, but no advance beyond the preliminary discussion stage was made because of lack of time.

The agreement between the United Kingdom and the Government of India shall remain in force until a date six months after notice of denunciation has been given by either party. Any change in the rates of duty shall be notified by either party to the other with a view to adjustments being agreed upon. Also consult my articles on the subject in the *Indian Review* of May, 1931 and the *Modern Review* of November, 1932.

the corresponding figure for 1933-34 was 1,75,000 tons. This is an outstanding achievement of the Ottawa Agreement.

Indian tea and coffee did not get any benefit by the Agreement. There was a decline of 30 million pounds of Indian tea consumed in England during the year 1933-34 as compared with the figure for 1932-33. Dr. Meek explains that this was due to the export restriction scheme put into force in 1933-34, but he claims that the percentage of Indian tea consumed in the British market remained constant. Indian cotton yarn, raw cotton and pig iron improved to the extent of 2,42,000 pounds, 11,000 tons and 1,15,000 tons respectively ; while jute did not receive any stimulus.

On the import side Great Britain has got almost a sheltered market. It is, of course, difficult to prove this point fully ; because the quantity of consumable goods has gone down during the last few years owing to the decline in the purchasing power of the Indian masses. But in any case, England could not have attained her past position in this respect. She could, however, hold her own as compared with non-Empire competitors in the Indian import markets. British building and engineering trades, chemical industries, medicines and drugs, woollen manufactures and aluminium, earthenware and porcelain have all benefited from the ten per cent. extra preference enjoyed in the Indian market during the last two years. The Indian aluminium trade has been hit very hard as a result of the Agreement.

According to Dr. Meek "the chief reasons why the consumer has not been adversely affected by the new preferential duties were that prices in most cases of imports from the United Kingdom have shown considerable decreases. No doubt, a part of this may have been due to a general falling tendency in prices of similar articles, but it cannot be denied that part of this decrease was certainly due to the reduction of duty in favour of the United Kingdom and the effect on international trade to such a degree that whatever trade remains is subject to severe competition."

There is one important test which should be applied to establish the fact that a trade agreement was beneficial to a country. It should be shown that it rehabilitated her overseas trade. The Ottawa Agreement cannot stand this test. Our vast usual favourable balance of trade, which was Rs. 157 crores in 1925-26 was reduced to a *minus* balance of Rs. 15 lakhs in 1932-33 ; but there was improvement during the year 1933-34.

The rehabilitation of our overseas trade particularly on the export side should be our prime concern and if it can be shown that the Ottawa Agreement has restored it, the same

should really be said to be advantageous ; but it seems it has not assisted us in regaining this position. Canada, Ceylon and Australia have not really kept up the Agreement and when its period expires, India should also reconsider her position in this respect.

INDO-BRITISH TRADE PACT

The Indo-British Trade Pact was signed on January 9, 1935, and it is supplementary to the Ottawa Trade Agreement. It is to operate during the continuance of the Ottawa Agreement. The following are the main provisions of the Pact :—

(1) Protection to Indian industries may be necessary against foreign competition to promote the economic well-being of the country ; but "conditions within the industries in India, in the United Kingdom and in foreign countries may be such that the Indian industry requires a higher level of protection against foreign goods than against the imports of the United Kingdom origin."

(2) Revenue considerations will be given due weight in fixing the Indian import duties.

(3) The Government of India undertake that protection will be accorded to Indian industries in accordance with the policy of discriminating protection.

(4) The measure of protection "shall only be so much and no more than will equate the prices of imported goods to fair selling prices for similar goods produced in India and that whenever possible.....lower rates of duty would be imposed on the goods of the United Kingdom origin." Differential margins of duty established in accordance with the provisions of the Pact shall not be altered to the detriment of the United Kingdom goods. For revenue purposes, the Government of India can impose an over-riding revenue duty on imported goods higher than the protective duty required.

(5) When the question of grant of substantive protection to an Indian industry is referred to the Tariff Board, the Indian Government will give full opportunity to the industry concerned in the United Kingdom to state its case and answer cases presented by other interested parties. Further, the Government of India "undertake that in the event of any radical changes in the conditions affecting the protected industries during the currency of the period of protection they will, on the request of His Majesty's Government or of their own motion, cause an enquiry to be made as to the appropriateness of the existing duties.....and that in the course of such enquiry full consideration will be given to any representations which may be put forward by any interested industry in the United Kingdom."

(6) His Majesty's Government will consider the steps that might be taken in co-operation with commercial interests to develop the imports from India of raw materials or semi-manufactured goods used in manufacturing articles which on importation into India are getting preferential treatment.

(7) Indian pig-iron will be admitted duty-free into the United Kingdom market so long as duties applicable to articles of iron and steel imported into India are not less favourable to the United Kingdom than those provided for in the Iron and Steel Protection Act of 1934.

CRITICISM

The main arguments against the Pact are :—

(1) The right given to any industry in the United Kingdom to ask for re-examination during the period of protection introduces an element of uncertainty to a great extent. The Agreement will impede the industrial development of the country, because the impetus to starting new industries will vanish. The fact that the continuation of protection will not be certain will prevent people from investing their capital in industries in India.

(2) The preamble of the Agreement lays down that it would remain in force as long as the Ottawa Agreement lasts ; but this clause under the new Constitution might be misinterpreted and the Pact might be allowed to continue on the ground that its termination amounted to commercial discrimination.

(3) The Agreement introduces three new principles : firstly, the application of the principle of discriminatory protection has been restricted ; secondly, India has been committed to the principle of safeguarding British industries ; and thirdly, India has parted power to negotiate a trade agreement with other countries on a free basis.

(4) Prior to the Pact the fair selling price was not the only test for giving adequate protection ; whereas under the Pact the test of the fair selling price would be the only test. This will prevent the grant of protection to an industry on any ground other than the test of fair selling price.

(5) The discretion of the Tariff Board will not be left unfettered inasmuch as the Agreement gives His Majesty's Government the right to be heard ; whereas the United Kingdom Government has not given a similar right to the Indian Government. The Agreement is not therefore based on the principle of reciprocity.

(6) The five pledges given under the Agreement by the Government of India will undermine the fiscal autonomy which

India is enjoying at present. If India has to lower the rate of duty on goods of United Kingdom origin; if India cannot alter the difference and the margin of duty to the detriment of British goods; if British interests can move the Indian Government to cause an enquiry to be made even as to the appropriateness of the existing duties; and if India is bound to reduce duties substantially on the imports of British cloth even if such reduction destroys protection, then the Agreement is really disadvantageous to India.

(7) Indian commercial interests were not consulted by the Government when the Agreement was under negotiation; whereas full opportunity was given to British industrial and commercial interests by the United Kingdom Government. This naturally raised suspicion and doubts in the minds of business men in India regarding the nature and effects of the Agreement.

DEFENCE OF THE AGREEMENT

The following arguments were advanced by the Government in favour of the Agreement :—

(1) The Government would continue their adherence to the policy of discriminating protection as in the past and that the policy would be applied in the future in the same manner as it was done in the past.

(2) In the conduct of enquiries by the Tariff Board, the Government had always allowed industries, whether British or foreign, to state their case frankly in the interests of the Indian consumer and tax-payer.

(3) The Government never abandoned its duty of re-investigating the case of an Indian industry if radical alterations occurred in the conditions affecting the industry.

Thus "We have done nothing more than crystallize our past fiscal practice and principles which have been accepted and laid down either directly or indirectly by this Legislature. This also explains why it was not necessary to consult commercial opinion in this country."

The question is : Where was the necessity of the Agreement if merely the past policy was to be crystallized thereby ? The necessity of the Agreement at this juncture was explained by Sir Joseph Bhore in the Assembly when he pointed out that the British interests merely wished that India's policy should be defined so that there would be no misunderstanding hereafter and that so far as the Government were concerned, this agreement merely implemented the implied promises given at Ottawa and the definite promises given to the Clare-Lees deputation. It was also pointed out that more than

anything else the Agreement would relegate the safeguards to the region where they would lie unused.

The Pact was rejected by the Assembly ; but the Government disregarded the vote of the House and allowed it to continue. There is a great possibility that in practice the Agreement might affect the interests of Indian industries prejudicially and prevent the planning out of a policy of industrialization along right lines.

EXCISE AND EXPORT DUTIES AND BOUNTIES

Excise duties are taxes levied on goods produced within a country and destined for local consumption. They are collected from the producers and wholesale traders, but if goods are to be exported a refund is made to the persons concerned. They are also levied on alcohol and tobacco partly because they are very productive of revenue and partly because they discourage the consumption of those commodities. In the United Kingdom the tendency of modern legislation has been to throw the largest possible burden of excise duties on alcoholic drinks and to exempt other articles. In the British colonies and the U.S.A. excise taxation has been largely confined to alcoholic liquors and tobacco ; but on the continent of Europe many countries have applied it to other articles as well, such as sugar, salt and matches. In 1901 the Government of Egypt imposed excise duties on cotton goods and so is the case with Japan which levies a consumption tax on kerosene and sugar also. In India excise duties have long been levied on alcohol, opium and drugs. An excise duty of Rs. 1-4-0 per maund is levied at present on salt, of six annas a gallon on motor spirit and one anna per gallon on kerosene. A surcharge is now levied on these goods as a result of the Supplementary Finance Act of 1931.

They are economically justified because the imposition of equal excise and import duties is a sound method of indirect taxation where the home industry does not require any protection. It raises the price by a lower amount than a single duty of either kind to produce the same revenue and hence the injury to consumers is less than if a single duty of either kind is levied.

The imposition of excise duties on small or scattered industries is unsuitable because of the high cost of collection. As a general rule, therefore, they should be confined to industries which are concentrated in large factories or in small areas affording facilities for collection, etc.

In the case of a commodity injurious to the individual or dangerous to society, the excise duties can be usefully levied as a means of checking its consumption. Apart from this, they must be levied purely for revenue purposes.

In order to produce sufficient revenue an excise duty must fall on a commodity of general consumption. This indicates the limitation of excise duties in case of a country like India where people are very poor and an excise duty as that on salt is disadvantageous from their point of view.

When an industry requires protection any further necessary taxation on its products can be raised by excise duties provided they are fully counterveiled by import duties. The import duty should never be lower than the excise cess, but in some cases it may be pitched at a higher level. Where the local product is inferior, the additional import duty should be higher than the excise duty.

Export duties are taxes levied on the export of commodities from a country for purposes of producing revenue or for protective purposes also. The incidence of an export duty depends upon the conditions of the supply and demand of a commodity. If the commodity is such that the exporting country has a monopoly of the supply of the commodity, an export duty thereon will raise its price provided the demand for it in the foreign country is inelastic or strong. Under such circumstances, the rise in its price will be equal to the amount of the duty levied and its incidence will fall on the foreign consumer. But if the proportion of the world market supplied by the country imposing an export duty is small, its price will not rise by the full amount and its incidence will fall on the home producer. If the producer raises the price by the full amount, he will be undersold provided other countries also compete in the supply of the commodity and they send it free of tax or have other advantages. Only in case of an absolute monopoly will the duty fall on foreign consumers provided they have an inelastic demand for it. Such cases are, however, extremely rare and, therefore, it can be said with confidence that some portion, if not the whole of an export duty, falls on the home producer. Under such circumstances it naturally reduces the production of the commodity.

Even if the monopoly of the country is undisputed in the export of the commodity, then also the duty falls upon the home producer to a great extent. If its price rises, the foreigners will use substitutes for the commodity; but that will depend upon the rise in the price of the commodity and the availability of substitutes. Export duties are advocated for protection as well as for revenue purposes. If an export duty is levied for protection it either raises the cost of the raw material in the foreign country or reduces the cost of the raw material at home. The home manufacturer benefits in both cases. The peculiar characteristic of an export duty is the fact that the

protection operates on the raw material of the industry and places the whole foreign product at a disadvantage; while a protective import duty gives the disadvantage only to that portion of the foreign product which enters the home market.

An export duty is disadvantageous from the following points of view as a means of protection. Firstly, it antagonises the foreigner by raising the price of the raw material in the foreign country. Secondly, it taxes production instead of consumption. Finally, an export duty to be effective for protective purposes must be very high for raw materials from a very small proportion in the cost of production of the manufactured goods generally. To produce its effect the export duty must be very high. Its high price will make substitutes available in the foreign country and the burden may mostly fall on the home producer.

The Indian Fiscal Commission recommended the levying of export duties only for revenue purposes provided the duty fell mainly on foreign consumers and its production in India was not discouraged.

Bounties.—A bounty is a payment made at intervals by the Government of a country to producers of a certain commodity whose production is sought to be encouraged. It may be given in proportion to the quantity of goods produced or sold or exported. It is, therefore, very similar in its effects to a protective duty inasmuch as the object of both is to stimulate the production of a commodity and both have a tendency to turn labour and capital into a different line.

It also differs from protection. A protective tariff encourages an industry by reserving the home market. A bounty, on the other hand, enables home producers to meet foreign competition more easily not by raising prices but by lowering them. Another difference is that a protective duty enables home producers to charge high prices, but a bounty enables them to charge lower prices than they otherwise could do. A bounty is more effective than a protective duty for the latter can guarantee them only the home market, but makes it difficult to capture foreign markets as it raises prices and incomes by encouraging the imports of money. A bounty, on the other hand, enables home producers to charge lower prices and thus they can capture foreign markets as well. Thirdly, a protective tariff gives the advantage at the cost of consumers; while a bounty gives the advantage at the cost of tax-payers.

A bounty is less objectionable than protection for the encouragement of an infant industry at home. A bounty system involves taxation which is very much resented and it will not be voted upon unless it is very desirable. Further,

protection creates vested interests and its withdrawal becomes very difficult. The bounty can be more easily withdrawn for its withdrawal will mean reduction in taxation. Bounties should, therefore, be given in those cases where an industry is to be encouraged and when its produce is mostly consumed by poor people. In that case they will have no burden in the form of high prices, but will actually get relief and the burden will fall on the rich for taxes are levied on the rich unless they are indirect.

Its effect on nominal wages will be that they will rise, because in order to increase production more must be paid to wage-earners. But real wages may not rise or may even be lowered if the bounties are paid by raising indirect taxation for in that case wage-earners will also be affected.

The effects of bounties upon price level in the home country and upon economic welfare are :—

Bounties may be only so high as to enable producers merely to capture the home market. This will decrease imports of commodities and if exports do not decrease much money may flow into the country raising the general level of prices and money incomes in the bounty-paying country till equilibrium is established. If they are high enough to cover even the transportation cost, the producers may capture the foreign markets as well. This will have exactly the same effects as in the above case.

The effect upon economic welfare depends upon whether the trade is directed to less advantageous channels. If so, economic welfare will be damaged. Their effects in general are the same as those of a protective tariff.

CHAPTER XVIII

Banking and Functions of Banks

THE term "bank" has been defined in various ways in text-books on Economics. Modern banking operations are becoming diverse in nature and specialization and division of labour play a very important part in banking business also. There are some banks which usually supply finance for industries for fairly long periods of time, some specialize in manufacturing agricultural credit, others finance international trade, some lend short-term finance to those engaged in trade and commerce and the main duty of some types of banking institutions consists in so conducting and guiding smaller banks and in controlling the money market conditions that national interests may be served best. Thus it is not possible to give a concise and clear-cut definition of the term "bank" which will include the functions and services of all these various forms. It is probably well to disregard all definitions of the general word "bank" and substitute in its place qualifying phrases which designate clearly the nature of the business performed by a particular type, e.g., commercial banks, industrial banks, mortgage banks, exchange banks, savings banks, etc.

There is one drawback of the above classification. No one particular class of banks performs the functions which the classification would seem to suggest. Industrial banks, for instance, do not confine themselves exclusively to raising long-term finance and investing it in industries. Commercial banks do not in all countries confine their activities to short-term lending and borrowing of money. On the continent they perform the functions of industrial banks also. Indigenous banks and money-lenders in India combine money-lending, banking and trade. A general definition which does not include and denote all these duties and services of various classes of banks should thus be considered unsatisfactory. *The most common definition of a bank is to call it an institution which deals in money and credit.* This definition is, however, very limited in scope and conveys a very imperfect idea of the duties and services rendered by modern banks. Broadly speaking, a bank is an institution which borrows money from those who save it and lends same at reasonable rates of interest to those who can properly utilize that money in trade, commerce and industries of various types. It acts as the custodian of the

funds of its customers and helps them in times of need with money and expert advice. It does not usually grant accommodation without adequate security.

VARIOUS CLASSES OF BANKS

There are various classes of banks performing different functions. There is no clear-cut division of the functions of these various classes, but there is a certain class of business commonly performed by certain institutions which entitles them to belong to a separate category. It does not, however, mean that in actual practice institutions coming under a certain class do not take up business commonly done by institutions which fall into some other class. The operations of each class may be studied in detail.

Commercial banks are those institutions which raise short-term finance in order to lend it for short periods. Such banks raise loans for six months or a year at the most and lend it to businessmen and traders for corresponding periods. They do not furnish the whole fixed capital for trading purposes, but supply only as much as is needed for carrying on businesses. Such banks encourage only genuine borrowing as distinguished from speculative borrowing. The depositor can demand his money at the expiry of the short period of time and, therefore, commercial banks should employ such money in self-liquidating and rapidly maturing securities like genuine bills of exchange.¹ Thus orthodox theory forbids the granting of long-term loans from short-term deposits. In actual practice, however, commercial banks lend money for investment purposes, help speculators and also grant loans for purely consumption purposes. Such banks thus perform functions which orthodox theory would not assign to them. In Germany, France, other continental countries, the U.S.A., etc., they combine commercial operations with investment functions.

Savings banks are institutions which cater for small sums of money and their main object is to promote thrift. They pool the resources of people of small means and lend them to businessmen and to others on the security of real estate. By law their choice of making loans is limited and they can lend on best and the safest security. Such banks do not maintain handsome reserves because the amounts of deposits received by them from their customers exceed the possible

¹ Adam Smith writing about the functions of a bank says, "What a bank can with propriety advance to a merchant or undertaker of any kind is not either the whole capital with which he trades or even any considerable part of that capital, but that part of it only which he would otherwise be obliged to keep by him unemployed and in ready money for answering occasional demands." *Wealth of Nations*, 1893 Edition, p. 231.

withdrawals. In England and the U.S.A. there are a very large number of such institutions and in the former country the Trustee Savings Banks have been overshadowed by the Post Office Savings Banks.

There are special institutions called co-operative banks and land mortgage banks which have specialized in agricultural finance for short and long periods respectively. The latter grant loans on the security of landed property and they have an expert staff of their own to assess the value of the property mortgaged. The former ones differ from joint-stock banks in various ways. Firstly, the co-operative banks cater to the needs of the poor people, the cultivators and labourers and the joint-stock banks receive deposits and lend money to the rich and the middle class people. Secondly, the co-operative banks give more emphasis to honesty and character of the borrower in matters of loans. If people who are very honest have no collateral security to offer the banks will lend money to them against bills of exchange, whereas the joint-stock banks lay emphasis on material tangible security. The co-operative banks also supervise the cultivators in connection with the use of these loans, but the joint-stock banks usually do not do so. The latter will be satisfied if their security is good and will not have anything to do with how the borrowed money is spent by the borrowers. Thus co-operative banks capitalize the honesty of the people.

The industrial banks lend money to large-scale producers with which the latter purchase their various assets including land and buildings and they supply long-term loans. They have experts to advise them with regard to the prospects of new businesses requiring loans and with regard to existing concerns also. They have a very high paid-up capital and usually exercise effective control over companies to which they lend money.

The exchange banks finance the foreign trade of a country and deal in foreign bills of exchange. They also handle gold and silver in this connection.

The investment banks and trust and finance companies collect funds to be utilized for productive uses. They lend money for long periods and attract capital through debentures for 20 or 30 years and usually they have a very large paid-up capital of their own which they can lock up in lucrative assets. They discount bills of exchange, lend money on approved securities, on the mortgage of land, house and shop property and underwrite securities, etc.

It should be emphasized that a clear-cut specialization of the type described above does not usually exist in practice.

Each of these types performs duties which have been described above as belonging to others. The efficiency of the banking system of a country depends upon a close relationship and interdependence of these various institutions.

ECONOMIC SERVICES OF BANKS

Banks afford numerous facilities to businessmen and to their customers. They hold the funds of their customers in safe custody and honour their cheques drawn upon them. They collect cheques, bills of exchange, interest and dividend for their customers and advise the latter with regard to the status of individuals and corporations to whom credit may be allowed. They promote the financial stability of their customers because credit can be granted to the latter on the recommendation of the bank.

Banks collect money from various sources and make it available in suitable sums to those who can make a proper use of it. Thus they help in the accumulation of capital and in increasing production. They create purchasing power in the form of cheques and other marketable securities. With the help of the banks easily marketable wealth of every kind can be converted into purchasing power. Banks furnish their customers with expert advice and the possession of a bank account stimulates thrift, economy and saving on the part of customers. The banks in modern times are the nerve centres of the modern world and a failure of banks paralyses to a great extent the entire economic organization of society. Bank failures bring in their turn lessened production, declining number of exchanges, business depression and a decline in the volume of trade and employment. It is true that the economic prosperity of the people of a country depends upon natural resources, social system, national character and the availability of skilled labour; but a good banking system is very useful to make increased production possible. It improves the tone of credit and the business morality of society to a very great extent. Honesty, good faith, sound business principles and the sanctity of contracts are qualities which are promoted by a good banking and credit system. The increased production of the post-industrial revolution period has been due to the widespread and thorough organization of banking business conducted under sound and expert guidance.

A bank plays a very fundamental part in releasing the necessary economic energy which stimulates the accumulated resources of a large number of people in order that they may be available for industrial development. It exercises a wholesome influence over industries financed through it. Through the discounting policy and reserves, the industrialists and businessmen can be made to do what is necessary and desirable which

probably, left to themselves, they would not do. If a businessman or an industrialist comes to know that accommodation for working capital would be withdrawn, he can be made to follow a policy of re-organization, expansion or rationalization as desired by the banks. Banks are expected to select the right type of men and enterprises to finance and in this way they exercise a great power in moulding the economic activities of a country along right lines. The wholesale and retail dealings, transportation and other phases of economic activity which depend upon borrowed money are under the influence of banks and bankers.

Modern production is round-about and the processes of production are indirect. A great deal of time and capital is required for commodities to be produced. Real capital, labour and raw materials are necessary and before the finished product can be obtained, commodities have to pass through various stages. During this time, raw materials have to be paid for and money is required to be given to labour and to incur repairs and renewals to old and worn-out buildings and machinery. This is done through banks which finance practically every operation of production. The connecting link between the various activities of industrialists, manufacturers and growers of raw materials, etc., is the banker.

BANKERS AS MONEY CHANGERS

Early bankers were money changers and they facilitated trade and commerce by changing one currency for another because in the same country there was a bewildering multiplicity of coins. Gradually they began to provide safeguards for their customers and issued receipts to them for deposits. This was the basis of credit and people entrusted their money to those banks only in whom they had implicit confidence. These receipts could be handed over to creditors who could get gold on presentment to the drawee banker. This receipt gradually assumed a standardized form and to day it is known as a cheque through which money can be withdrawn from a bank.

Gradually the note-issuing function came into existence. It was in this way. Some gold lay redundant with banks which they could lend on interest. The loans took the form of actual gold or the signed notes of the bank to pay gold on demand to the holder. The State in the early stages did not exercise control over this function and hence a large number of banks issued notes to an extent that was far beyond their capacity to redeem them in gold on demand. The result was a series of failures of banks and the loss of money of innocent people and a consequent loss of confidence. Gradually the State began to exercise control over note-issue which is now regulated by law in all countries, and in most countries the

note-issuing business is undertaken by and allowed only to central banks.

THE CHEQUE SYSTEM

In industrial countries and specially in towns the cheque system plays a very great part in facilitating exchanges in various countries of the world. A cheque is accepted only in a narrow area and is accepted in payment only from known parties. Customers are given the right to draw cheques on balances to their credit on current or drawing accounts at their convenience and for amounts required by them. A cheque for an amount higher than the one which exists to the credit of the customer in his banking account will not be paid unless there has been a previous agreement between the bank and the customer and the banker has allowed the customer to overdraw his account. Deposits subject to cheques play a large part in facilitating exchanges and in some respects a cheque is better than a note. A note may be stolen, but if a cheque is stolen the banker will refuse payment if informed in due time. A cheque is useless without being filled in and signed and even when it has been completed a customer has certain safeguards to save himself from the risk of loss. It can be filled in at any convenient time and for any convenient amount within limits. Hence the cheque system is developed very highly in busy towns and centres. These credit instruments are useful as they save gold and facilitate exchanges.

BALANCE-SHEET OF A COMMERCIAL BANK

| Liabilities | Amount Rs. A. P. | Assets | Amount Rs. A. P. |
|--|---------------------|--|---------------------|
| Authorized Capital .. | | Cash at Hand .. | .. |
| Subscribed Capital .. | | Cash at Bankers .. | .. |
| Paid-up Capital .. | | Call Loans .. | .. |
| Reserve Fund .. | | Bills Discounted .. | .. |
| Deposits .. | | Advances .. | .. |
| Notes .. | | Investments .. | .. |
| Bills Payable .. | | Bills Receivable as per <i>contra</i> (acceptances for which customers are liable) .. | .. |
| Bills Receivable (acceptances on behalf of customers) .. | | Bank Premises and Dead Stock .. | .. |
| Profit and Loss Account | | | |

The above is an imaginary balance-sheet of a bank showing the assets and liabilities. A balance-sheet is that statement which is prepared by the owners of a business concern with a view to find out the financial position of their business ; and, properly prepared, this should enable people to know the financial position at a glance. In case of joint-stock enterprises the preparation and publication of the balance-sheet is obligatory at law and the same has to be certified by auditors.

On the left hand side, in the above case, the items are known as "liabilities" and those on the right hand side are known as "assets" of the bank. The term "liabilities" refers to those items for which the banker is responsible to make payment to other people. In the case of the paid-up capital and the reserve fund the bank has a permanent liability to its shareholders. The assets are the property of the bank including cash and the bank has a right to receive money in case of these items from its debtors.

"Authorized Capital" is the amount of capital with which a bank is registered and on which it has to pay some registration fee. The whole of it is not offered to the public to be purchased by the latter, but only a part is offered and subscribed by people. The portion purchased by people is known as subscribed capital. Actual cash is not immediately paid by the purchasers of shares. Some money is paid on application and some when shares are allotted to them. Later on the bank calls upon them to pay as much as it requires and the shareholders cannot be asked to pay in aggregate a sum exceeding the face value of the shares held by them. The portion which has actually been paid in cash is known as paid-up capital. The portion which the shareholders have been called upon to pay is known as called-up capital and if calls have not been paid in full, the unpaid amount on calls is known as calls in arrears. If the calls are not paid in due time, the shares are liable to be forfeited by the bank. A certain portion of the capital is left uncalled and is known as reserve liability. It is usually called up only in the case of liquidation and it is a sort of guarantee to those who deposit their money with the bank.

"Reserve Fund" is that portion of the profits of a bank which is not distributed among the shareholders by way of dividends and it strengthens the position of the concern. In some cases when the bank is in a flourishing condition, its shares can be sold in the market for a higher amount than their face value. If, therefore, fresh shares are issued, they can fetch more than their face value and the excess of the sale price over the face value goes to the reserve fund. The bank can use this fund in cases of emergency when it is sustaining losses and it strengthens the financial position of the bank and also inspires confidence in the minds of customers. This fund is invested by the bank in good securities from which an income is obtained.

Bank deposits consist of cash or titles to cash deposited by customers. People deposit their money with the bank for a fixed period of time which they cannot withdraw without the expiry of the period unless the bank allows them to do so. They are known as fixed deposits from which money cannot be withdrawn by cheque. Deposits may be made into current

account from which money can be withdrawn by cheque at the convenience of the customer during business hours. Actual cash may be deposited by the customer with his banker or certain titles to cash may be deposited for collection as cheques, bills of exchange and dividend warrants for which the customer has to receive payment. The bank may also grant loans to its customers and to this extent the customer can draw upon the banker in favour of his creditors. This comes to the same thing as if the customer has actually handed over cash to his banker on which he can draw later on. A customer may like to discount a bill of exchange and the actual present value of the bill *minus* discount may be paid to the customer or as usually happens the present value of the bill is credited to the account of the customer while the discount is debited. Thus deposits are not made in cash only but created also and a vast majority of deposits are not paid in cash to the bank, but consist of credits borrowed from the bank. The customers draw cheques against them. This right may be created by the customer or by the banker and in whatever way it may be created, the banker must be prepared to meet the obligation as soon as it is exercised by the customer.

The creation of credits by the bank depends upon its cash resources. A bank must have adequate cash resources to meet his customers' demands. Thus credits can be created on the strength of the cash resources, but the banker can lend more money than his actual resources. He knows that all the customers will not exercise their right at the same time and in the words of W. S. Jevons, "The whole fabric of our vast commerce is found to depend upon the improbability that the merchants and other customers of the banks will ever want simultaneously and suddenly so much as 1/20 out of the gold money which they have a right to receive on demand at any moment during banking hours." Deposits thus may be created to the extent of four or five times the amount, but a banker should follow a sound banking policy so that prices may not be affected.² Customers usually keep a minimum balance in their current accounts which is utilized in creating credits. The banker knows by experience that

² Professor G. Cassel in his book *Money and Exchange after 1914*, writes on page 103, "The supply of credit must be so regulated that no rise in prices and naturally no fall in prices either takes place. In order to keep demands for credit within the limits of available means, the bank must apply interest rates fixed with that object in view, but in their continual scrutinizing of the demands for credit must also be able to effect the necessary restrictions. The main factor determining interest rates throughout the entire banking system is the Central Bank's discount rate and in addition the Central Bank naturally possesses a very great influence owing to the general advice it is able to give to private banks as to their credit policy."

this amount would not be drawn upon and usually interest is not allowed if the minimum balance is reduced.

The note-issuing business is not undertaken now by commercial banks and is reserved generally for Central Banks.

"Bills Payable" are bills drawn by the banker upon his agents and sold to people who want to remit money to other places. They have got to be paid on presentment and are liabilities. The bank may also have accepted certain bills on behalf of its customers which it has got to pay on maturity and such bills are included in this item. This latter class is known as acceptances on behalf of customers.

"Profit and Loss Account" means profits earned during the year together with the same brought forward from the previous year. Out of this sum dividends are distributed to the shareholders and the residual undistributed amount is included in the balance-sheet.

The first two items on the assets side constitute the cash reserve of the banker. The latter amount, *i.e.*, "cash at bankers" is held at the Central Bank.

"Call loans" means money lent for not more than seven days or over-night money also. The bank has a right to demand this money within 24 hours. If the demand for discounting bills is slack these loans furnish an outlet for funds that would otherwise remain idle. They are usually made at very low rates of interest varying from 1 to $1\frac{1}{2}$ per cent. because they are granted on first class securities and the borrowers are men of good standing. They are the first line of defence as the security on which they are given is readily marketable. A high rate for call money does not mean much profit to the bank, because private individuals withdraw money from the bank and lend it to borrowers.

"Bills discounted" means bills of exchange purchased by the banker and payment may be made immediately or the amount may be placed to the credit of the customer on which he can draw later on. Discount is the profit to the banker in such cases. The banker has a right to obtain payment at maturity from the drawee.

"Advances" are loans given by a banker to his customers on the strength of some security. They may be granted on the security of promissory notes or may be the result of a customer's overdrafts arrangements with the bank. A bank should take the following precautions in granting loans and advances :—

- (1) A very large amount should not be given to one individual but should be given to a large number, because the latter leads to the distribution of risk.

(2) The nature of the security should be judged aright. "A perfect banking security should combine ultimate safety, a certainty of payment on a specified and not a distant date, a capability of being converted into money in case of unexpected emergency and a freedom from liability of depreciation."

(3) Too much of one single class of securities should not be accepted as cover for loans, because in the event of sale the bank will suffer a great loss by a fall in their market price brought about by large sales.

(4) The banker should keep a good margin in his favour and normally ten to twenty per cent. margin is necessary according to the quality of the security.

(5) Honesty, integrity and financial standing of the borrower should be scrutinized even though sufficient collateral security is deposited with the bank.

From the bank's point of view all loans can be classified under (1) Loans on stock exchange collateral, and (2) Loans on commercial paper. Loans on stock exchange collateral are granted to bill brokers and stock brokers for short periods. If customers on the pledge of securities require the opening of a loan account the bank reckons this under the heading of "loans on stock exchange collateral." Commercial paper includes overdrafts, loans on the security of promissory notes, cash credits and personal loans to big commercial people.

Loans may also be classified according to the period of time for which they are granted. Short-term loans are those which run from a single day to about 90 days. Long-term loans range from six months or more as the case may be to several years.

Coming to the study of loans themselves, an overdraft is the result of a previous arrangement with a banker who allows the customer to withdraw cheques for a sum higher than that standing to the credit of the customer in current account. This is done on the strength of some security. "To obtain an overdraft the head of the firm calls on or writes to the bank and advises it that it wishes to overdraw its account for a prescribed amount and the bank then honours cheques against it for approximately that amount—the sum is never rigid and the extent of the overdraft is left to the requirements of the firm."³ A cash credit is an advance on current account. The customer has to pay interest on the amount of his debit balances from day to day. Interest is charged on the amount actually withdrawn and the customer can repay any portion

³ *Domestic and Foreign Exchange* by Cross, p. 64, quoted by Dr. Ram Chandra Rau.

of the borrowed sum whenever he likes. In India the customer has to pay interest on a minimum balance whether he may or may not withdraw that sum.

"Investments" means the holding of gilt-edged securities and other first class bonds in which the bank has invested money. Broadly speaking, the operations of banks of discounting bills and making loans may be called as different methods of investing money. A banker prefers commercial paper to stock exchange collateral and the latter are preferred to staple commodities and real estate. This is the order of the bank's preference. A bank does not find investment business so profitable as loans and discounts. It can make profits only if there is a possibility of rise in the prices of securities, but it should not speculate in the value of these securities to make profits. What proportion of funds should be invested by banks in gilt-edged securities does not depend upon any *a priori* rule. The usual practice is that the capital and reserve fund are usually invested in interest-bearing securities. The paid-up capital and reserve funds do not belong to the public and cannot be called up from the bank. Much more can be invested, but this depends upon the stability of the bank and upon the confidence which it inspires into the people. In times of panic even government securities are unsaleable. In normal times they strengthen cash reserves, but in times of panic they constitute a real banking reserve available to meet a run on the bank and there is the risk of depreciation even in the case of first class securities.

"Acceptances" means bills of exchange accepted by the banker on behalf of his customers. At maturity the customer places the funds with the bank with which to meet them. The banks can profitably utilize their money in accepting the bills of their customers for commission and later on, in selling them in the market. Without spending anything of their own, the banks finance their customers and obtain profit by acceptance business. The total amount of bank acceptances must bear a definite relation to its resources and the common practice is for banks to accept bills up to the amount of their capital.

"Dead Stock" refers to buildings, office furniture, etc., which is necessary for carrying on the business. These assets are regarded as dead because the money sunk in them does not bring any direct yield to the bank.

BRANCH BANKING *Versus* INDEPENDENT BANKING

Branch banking permits the easy transfer of capital from places where funds are redundant to places where they are required urgently. Thus seasonal needs can be easily satisfied and interest rates tend to be equalized throughout the country.

Under branch banking risks can be spread in various industries because different branches existing in different localities can finance local industries and the failure of an industry to repay loans will not thus jeopardise all the branches. Hence branch banking leads to greater stability because local runs can be more easily met than under independent banking with smaller reserves. First class skill and efficiency at headquarters can be made available to all branch managers and internal and foreign exchange business can be economically handled and adequate banking facilities can be provided even in small districts. Local capital and skill can be utilized to the most profitable extent, because local men will regard it a matter of prestige in becoming the managers of smaller institutions rather than in being subordinates in large concerns where they may not be consulted on important matters. The opponents of branch banking point out that some of these advantages are not realized in practice and others are equally available to independent units. There are evils particularly applicable to branch banking from which independent banking is entirely free. The dangers of branch banking lie in monopoly power being used by monopolists and not in the existence of separate branches. The competitive waste of branch banking and the charging of high rates of interest in established localities to compensate the losses due to low rates of interest in undeveloped localities are other disadvantages pointed out against branch banking. The managers do not remain long enough at one branch in order to become thoroughly acquainted with local conditions.

CHAPTER XIX

Central Banks

QUESTIONS affecting the Central Bank have urgently required consideration during the last decade in almost all important countries of the world. The International Financial Conference met in Brussels in 1920 and one of its resolutions related to the fact that "in countries where there is no Central Bank of Issue, one should be established and this resolution emphasizes the close connection between the maintenance of financial stability with the functions of a central banking organization. In the following years the advice of the Conference has been widely followed and new Central Banks have been established in many countries; while the old ones have been overhauled." The Reichsbank was reorganized according to the Dawes Scheme and new Central Banks were established in South Africa, the South American States, and very recently in Austria a Reserve Bank was created while the country was on the verge of financial collapse. In India also one is going to be established at an early date.

In almost all cases the main reason of the establishment or reorganization of the Central Bank was to stabilize the currency system and to prevent over-issue and inflation. The lack of stability of the unit of value had introduced insecurity in contracts, capital values had been wiped out and the feeling of uncertainty regarding future conditions had created economic and social disorders in the world. To achieve stability of currency, the paper standard was replaced by the gold standard with the help of the central banking device. In order to maintain the established ratio between a currency and gold, the currency authority or Central Bank should buy and sell gold at a fixed parity on demand and there should be no bar on the free export and import of gold.

If the currency authority has an unlimited obligation to provide gold or gold exchange at a fixed price, it has a definite incentive to preserve its gold reserves when they are being largely depleted. This drain of gold is due to a disequilibrium in the balance of trade of a country, or to put it more accurately, in the balance of payments. This may be due to two reasons. Firstly, the country may have lent abroad larger sums of money than are warranted by its credit abroad and secondly, the

internal price level may be higher than the external price level. In both cases the remedy is to make the credit dearer by raising the discount rate. This will stimulate exports and discourage imports by lowering internal price level and attract funds to the country. In both cases reserves will be strengthened and also the internal need for money will fall and people will return notes to banks. In the reverse case the reverse remedy, *i.e.*, the lowering of the discount rate will be resorted to. Credit will increase and prices will rise and the issuing authority will issue more notes on the strength of the larger gold holdings.

Thus stable currency is very necessary and in most countries the responsibility of issuing notes is entrusted to a central banking organization for economic and political reasons. On the economic side there is a relation between the rate of discount, the note circulation and the volume of credit and the former is the chief instrument of regulating note-issue, credit and gold holdings and as the rate of discount is the instrument of a bank, it is desirable to entrust note issue to a bank. On the political side also the arguments for entrusting the note-issuing business to a Central Bank are weighty. The Government, if it has the power, may be tempted to raise money by issuing more notes when taxation will be very unpopular. Hence the note-issuing function is usually entrusted to banks.

The issuing authority may be a Central Bank as in England and other countries or several banks as in Canada till recently. The former is preferable because the latter alternative implies a divided responsibility and a lack of leadership and in the case of many issuing authorities there cannot be one controlling force to direct the monetary policy of a country, which is likely to be a source of weakness specially in a time of crisis as was the case with the U.S.A. in 1907.

There should thus be either a Central Bank or some other body like the Federal Reserve Board of the U.S.A. which is strong enough to carry out a definite line of policy. "The mere establishment of a Central Bank does not necessarily give this. The Bank must be so constituted as to be able to control credit and, in particular, to enforce a restriction of credit on the commercial banks if it considers it desirable to do so, for if the commercial banks could continue to lend freely in spite of a higher bank rate, the whole compensatory machinery for attracting gold and regulating the volume of notes in circulation would be invalidated. The Central Banks acquire the necessary influence through the fact that, in general, they control the reserves of the commercial banks and thus they are able to tighten the money market by appropriate operations which

have the effect of reducing the supplies of cash held by the commercial banks.”¹

The recent experiences of Poland and Japan can be cited in emphasizing the importance of the above considerations. The Polish currency heavily depreciated in 1925, because the Central Bank had no effective control of credit in the open market and consequently there was an excessive expansion of credit by the commercial banks because of which there was a very heavy strain on the international assets of the Bank of Poland.² In Japan there have been similar troubles on more than one occasion. A few commercial banks only keep their balances with the Bank of Japan or closely co-operate with it. At crucial times the raising of the rate of discount by the Bank has not been able to check the continued expansion of credit by the commercial banks and this has been one of the chief causes of the frequent financial crises in Japan.³

These are the reasons why new Central Banks have been recently established and many older ones have been overhauled. In Italy steps were taken in 1926 to unify under the Bank of Italy the note issues which formerly were in the hands of a number of banks. It is significant to note that the Irish Banking Commission in 1926 rejected the suggestion of entrusting the control of the currency to a Central Bank and proposed that it should be given to a statutory commission. The reasons were : Firstly, the lack of an independent discount market in Ireland and secondly, sterling then being the currency for Ireland, the Bank of England was the Central Bank for the country.

It may be said that from the point of view of currency stability the reorganization and rehauling of the Central Banks in various countries and the establishing of new ones in those where none exist is more necessary now than ever before because as a result of the collapse of the monetary standard to achieve the stability of price level, international co-operation is necessary. These objects can be attained through the help of Central Banks.

RELATION BETWEEN THE STATE AND THE CENTRAL BANK

The Government of a country is vitally interested in the efficiency of the Central Bank because if the latter fails it would involve an intolerable financial crisis in the country and the credit of the Government also would be adversely affected. The State usually keeps its balances with the Bank

¹ Kisch and Elkin, *Central Banks*, p. 9.

² *Statist*, 28th May, 1927.

³ G. C. Allen, *Currency and Exchange Policy of Japan*.

and for these reasons it cannot be indifferent to the policy of the Bank. By its discount policy and consequent reactions on credit, gold reserves and note issues, the Bank controls the purchasing power and hence there is a special relationship of the Bank to the Government of a country. In certain countries the Central Banks are conducted under a government guarantee as in Sweden. In Australia, the Government is responsible for all claims on the Commonwealth Bank. The main question is how much hand in the management of the Bank should be given to the Government.

In the pre-war period the tendency was to stress the control of the State over the Bank as in case of the Reichsbank prior to its reorganization according to the Dawes Scheme. Since the war the consensus of expert opinion has been to stress the independence of the Central Bank. The following resolution of the Brussels Conference, "Banks and especially a Bank of Issue should be freed from political pressure and should be conducted solely on the lines of prudent finance" crystallizes the general feeling on the point. The reconstruction schemes of the League of Nations for Austria and Hungary emphasized the independence of the Bank of Issue and the League's Financial Committee have been strong advocates of independent Central Banks. Even in countries where pre-war legal provisions are in force, the trend of opinion is against political control and a similar principle can be discerned in the recently established Central Banks in certain South American Republics. Even where the Banks are private, they do not aim at huge profits, but the economic advantage of the country is their foremost consideration.

In spite of the above trend, the Government in most countries have some influence in the matter of the constitution of the governing body of the Central Bank. The Bank of England and the Reichsbank of Germany are quite independent of Government at least on paper though not in actual practice. In practice there has been close and continuous co-operation between the Bank and the Government in England where the Act was passed at a time when individualism was the guiding principle in economic and political theory. In exceptional times there has been something more than this, because during and since the war right up to September 21, 1931, when England went off the gold standard, the financial policy, though a matter of legal enactment, has nonetheless been dependent upon the decisions of the Government. In matters as the embargo on gold exports, the issue of Treasury Notes, etc., the Government consulted the Bank, but probably if there had been a difference of opinion between the two authorities, the Government's view would have been the decisive factor. But except in abnormal times, the independence of the Bank is

secure. "The inner history of the Bank of England is known only to those in authority, but it is probably safe to assume that the relations of that institution with the Government present few difficulties that are not capable of amicable solution. The Bank has in the course of years built up a body of tradition and experience directed to the public service which is unrivalled and it may be fairly surmised that no Government in this country would seriously desire to intervene in its administration." (Kisch and Elkin, *Central Banks*, p. 19.)

As regards the Reichsbank the German Bank Act of 1924 stressed the independence of the Bank, but it was devised by foreign experts when the financial policy of the German Government was politically suspected and had proved unsound economically. Probably this distrust of Government influence would not have been so manifest if the reorganization had come from within the country. Even then the Reichs president was given a limited veto over the election of the Bank's president.

From these independent organizations there is a gradually ascending scale of Government control culminating in Russia where the Bank is subordinate to the Government. The Bank of Finland is another example of a true State Bank where the members of the Board of Management are nominated by the President of the Republic.

The theory underlying the conception of a State Bank centres on the proposition that because a sound national economic life depends upon a wise central banking policy, the Bank should be under the control of the Government which is the custodian of national interests. There are certain dangers of this course. Firstly, as the decisions of the Bank are of vital importance to the economic activities of the country, it is necessary that its direction should be as unbiased as possible. There cannot be a continuity of policy in case of a State Bank with changing governments and there cannot be freedom from political bias in its administration. The cases of the Bank of Spain in the latter part of the 19th century and of the Bank of France in recent years can be cited to prove the point. In both cases the Banks acting under Government compulsion exceeded legal limits for advances to the Treasury with the result that currency depreciated heavily. The financial crisis in France in 1926 was intensified by the depreciation of the franc which was caused by exceeding the legal limit from 41 milliard francs fixed in 1920 to over 3,000 million francs, with the result that the volume of notes in circulation rose to over 43 milliard francs. (Hon. G. Peel, *The Financial Crisis of France*, pp. 230-232.)

The Central Banks in Latvia, Australia, Sweden and Bulgaria are instances of State Banks ; but in practice they enjoy a wide measure of independence of Government. In these cases the Government and the Legislature have imposed on themselves to varying extents certain self-denying ordinances limiting their opportunities for intervention. If this could be done in all cases a State institution on a suitable charter could be as good as one independent of Government control, but the danger lies in the weakness of human nature to resist the temptation of creating credit when the machinery therefor is provided. To protect the Bank from undue governmental interference, it is necessary to make it an independent organization and to give such powers to the State as are necessary. But to establish a State Bank first and then devise machinery to give independence to the Bank seems to be futile. In the recently established or reorganized Central Banks the tendency is to move away from complete State control as in the case of the Bank Act of 1924 in Bulgaria and in Czechoslovakia.

The above conclusion is subject to one qualification. In an extreme national emergency all States have got a right to get purchasing power from the Bank which may mean expansion of note issue or the stopping of specie payments. The rejection of the conception of a State Bank does not mean that the State should have nothing to do with the composition of the Bank's directorate or in the general shaping of the relations between the Bank and the State. The degree of State influence varies widely in different cases.

DUTIES OF THE CENTRAL BANK TOWARDS THE STATE

The Central Banks manage the Government accounts and the business connected with the National Debt and generally act as fiscal agents without any specific remuneration. They usually have the custody of government deposits free of interest forming part of the Bank's working assets. The concentrating of the banking requirements of the State at the Central Bank has many administrative advantages which are amply clear from the history of the United States. Prior to the introduction of the Federal Reserve System, Government funds were distributed between 1,500 National Banks and nine sub-treasuries which materially influenced the conditions in the local money market by payment or withdrawals of large sums on State account to or from local banks. With the establishment of the Federal Reserve System the duty of apportioning these funds among the depository banks was given to the Federal Reserve Banks and they adopted various devices to avoid the upsetting of the money market.

Another point in connection with the relation between the Bank and the State is that a Central Bank as the note

issuing authority of the country is given a lucrative concession of a public nature and, therefore, has to surrender a portion of its profits to the State. In the charter of nearly every Central Bank regulations are embodied according to which a part of the profits after paying a graduated dividend and allotting some money to reserve funds is paid to Government. The Bank may also be exempted from the usual forms of taxation in lieu of this. The Reichsbank, the Banks of Greece, Austria and Hungary and of other countries enjoy such privileges. In England the Bank makes some statutory payments to the Government in consideration of exemption from stamp duty on its notes as the Government there does not partake in the profits of the Bank.

RELATIONS BETWEEN THE CENTRAL BANK, COMMERCIAL BANKS, AND THE MONEY MARKET

The duties and functions of a Central Bank as described by the Governor of the Bank of England in his evidence before the Royal Commission on Indian Currency and Finance should be as below :—

"It should have the sole right of note issue, it should be the channel, and the sole channel, for the output and intake of legal tender currency. It should be the holder of all the Government balances ; the holder of all the reserves of the other banks and branches of banks in the country. It should be the agent, so to speak, through which the financial operations at home and abroad of the Government would be performed. It would further be the duty of a Central Bank to effect, so far as it could, suitable contraction and suitable expansion, in addition to aiming generally at stability, and to maintain that stability within as well as without. When necessary it would be the ultimate source from which emergency credit might be obtained in the form of rediscounting of approved bills, or advances on approved short securities or Government paper."⁴

It will thus be seen that a Central Bank should be the holder of all the reserves of the other banks and their branches in the country. Banking reserves should be concentrated in a Central Bank in order that they may be mobilized for use at any place. These reserves should be maintained by the Central Bank in an extremely liquid form so that they may be available at a time of crisis. The Central Bank can expand and contract credit only if it has the control of funds and reserve balances of the commercial banks. It can then regulate the credit position as required by changing circumstances. The

⁴ Kisch and Elkin, *Central Banks*, p. 100.

commercial banks should keep their cash resources other than till money with the Bankers' Bank; otherwise they might deliberately oppose the policy of the Central Bank by expanding credit when that institution was aiming at restricting it. In turn, the commercial banks are entitled to expect of the central institution that it will carefully consider their views on matters of common concern subject to the fact that the Bank has a special responsibility for controlling credit. In the United Kingdom, for instance, banks keep their cash balances in the neighbourhood of 10 to 15 per cent. of their demand liabilities. This involves a practical limitation on their initiative in creating additional credit. They have no inducement to contract credit apart from their obligation of keeping the cash ratio. Thus expansion and contraction of credit rests with the Bank, which by its credit policy or operations in bills and securities increases or decreases the market supplies of cash and thus expands or curtails credit.

The credit policy of a Central Bank becomes effective by acting on the cash position and the lending capacity of the commercial banks. The question in this connection is whether the Central Bank should be allowed to enter into direct relations with the general money market or it should have dealings with commercial banks only. To prohibit the Bank by its Charter from having direct dealings with the general market is undesirable. At certain times credit restriction may be necessary to prevent excessive speculation and other unhealthy symptoms of trade or to correct adverse foreign exchanges; but if the commercial banks have huge cash resources, the discount policy of the Bank may be ineffective. Under such circumstances the Bank can reduce the market supplies of money by selling bills and securities on its own initiative in the open market which process should be continued till the discount rate becomes effective. With the diminution of the available cash supplies, a policy of credit restriction can be forced on the commercial banks. The Bank can also purchase bills and securities which can increase the cash of the commercial banks and thus a sudden stringency can be relieved at the initiative of the Bank and credit expansion is possible. Open market operations are thus very necessary and desirable.

There is another reason why open market operations should be allowed. The Bank has to employ its funds remuneratively under appropriate conditions and safeguards, but this will not be possible in the absence of open market operations by the Bank. This will also help the Bank in fulfilling its primary function of credit control. This has been the experience of the U.S.A. and England. In the latter country the Bank has also the power of dealing directly with the bill brokers and discount houses and thus maintains relatively

stable conditions when carrying out large money operations connected with Government and international finances.

This power should be exercised by the Bank with discretion and should always be subsidiary to its main function of credit control. The bank should not lend directly to manufacturers and traders because if it is bound by its commitments of direct lending to businessmen, credit restriction will be extremely difficult as it will be unwelcome to businessmen. Thus a Central Bank should not receive deposits from private customers. This restriction has been imposed upon the Federal Reserve Banks by the Federal Reserve Act. In other cases the limitation is indirect because the Bank cannot pay interest on deposits from private customers.

A Central Bank should keep its resources highly liquid and its business should be conducted on the safest lines to avoid bad debts. For this reason also a Central Bank should be excluded from direct association with industry, because loans to traders require frequent renewals and this is the business of commercial banks. This exclusion of the Bank is also desirable in the interests of maintaining good relations between commercial banks and the Central Bank. The Central Bank can inspire confidence if it does not compete with commercial banks and as the Bank has a free use of Government balances it should not take undue advantage of them. Its advice can only be accepted by the commercial banks if they have confidence in the Bank.

The credit policy of the Central Bank works through the transactions of the commercial banks. The latter look to the former for help and guidance in times of need. If a commercial bank is prudently managed and is sound it can get loans from the Central Bank on approved short-term securities and can also get approved commercial paper rediscounted at the Bank. The grant of these facilities is a unique service rendered by Central Banks. The Central Bank should not, however, act without proper care and discrimination, otherwise sound banking will not be possible. Business crises and bank failures can occur in countries having a Central Bank and the fact that these things take place is no criticism of Central Banks. Central banking is not a substitute for prudent banking, but "it affords the best basis for a sound banking and business economy and the surest safeguard for the stability of the currency".

In England the joint-stock banks do not directly look to the Bank of England for increasing their cash supplies and they do not get the help by rediscounting their bills with the Bank, but they withdraw funds lent by them at call or short notice on the market and the bill brokers and other

borrowers obtain the means of payment from the Bank. Even then the Bank is the ultimate source from which emergency credit is obtained by the market in the form of rediscounting approved bills or securities. Under the American and continental practice the banks rediscount their paper directly with the Central Institution.

The system of Central Banking in America and on the Continent differs from the English system in respect of the relationship of the Central Bank with the commercial banks and also in the matter of the legal regulation of the banking business. The nature of the business that can be undertaken by the Continental Central Banks and the Federal Reserve Banks is defined by law. There are, however, differences as regards the relations to be established with the public and the commercial banks. There are no restrictions in the case of the Bank of France and the Reichsbank in their business dealings with banks and other institutions. The Bank of France was to provide discounting and banking facilities even to the traders and this practice has been followed in drawing up the constitution of the Central Banks in Europe. In case of the Federal Reserve System and the Bank of Chile the character of the business to be transacted between the Central Banks and the commercial banks on the one hand and with the public on the other is clearly defined.

There is also a difference between the Federal Reserve System and the European system of central banking as regards the obligations imposed upon commercial banks in relation to the central institution. In the United States, certain of the South American Republics and South Africa the commercial banks are to keep some balance with the Central Banks. The main advantage of statutory deposits is to develop the Central Bank as a Bankers' Bank *par excellence*, but such rules may create a sense of false security as indicating that compliance with them is a sound position. A Central Bank in the last resort should justify itself by its work and if its authority is well established as in Europe, it is better for the Central Bank and other banks to work out their relations by negotiations with the minimum of legal stipulation and legislation should be resorted to only when other methods are not sufficiently efficacious. Legislation sacrifices an element of elasticity, but probably different conditions require different solutions. Where banks are comparatively smaller in number as in European countries the method of negotiation is suitable, but with a larger number of banks as in the U.S.A. probably legislation may be necessary. When the Central Bank has been superimposed on an existing system, the commercial banks which formerly did without it will be slow in appreciating its necessity and

in such cases a scheme of obligatory deposits by the commercial banks with the Central Bank is necessary because if these deposits are withheld the Central Bank cannot fulfil its objects.

OTHER FUNCTIONS

The sound functioning of a Central Bank depends upon its strict adherence to the terms of its charters and details apart, the main business of every Central Bank is alike in most essential respects. The Charter of 1924 of the Reichsbank defines the duties of the Bank as being "to regulate the circulation of money in the whole area of the Reichs, to facilitate the clearance of payments and to provide for the utilization of available capital."⁵ The main functions of a Central Bank flow from these responsibilities.

One of the most important duties of a Central Bank is to issue notes which gives the elasticity to the currency system of a country. This is necessary for the regulation of the monetary circulation and credit and for maintaining the established parity of the currency.

The dealings in precious metals and foreign exchange form another important function of a Central Bank. When gold is the standard of value some authority should buy and sell gold or gold exchange at a price fixed in relation to the established parity. It is then only that local currency will not rise or fall below gold parity by more than a small percentage representing the cost of sending the specie to or from the country concerned. The Charter of a Central Bank should, therefore, provide that the Bank should be able to deal in gold. The Bank of England before England went off the gold standard was under an obligation according to the Gold Standard Act of 1925 to buy gold at the price of £ 3-17-9 per standard ounce and to sell it at £3-17-10½ per ounce in quantities not less than 400 ounces. The object of imposing a quantitative limit is that the demands for gold on the bank should be only for foreign remittance and that demand for gold for domestic consumption should be supplied through other sources. "Under modern conditions where a gold circulation is generally in abeyance, and gold bought is paid for in notes or bank balances, it is convenient to concentrate the obligation of buying and selling gold at fixed prices in relation to the currency standard on the Central Bank, which can pay for it in notes issued against the gold," and this course has been recommended for India. Central Banks are also authorized to deal in silver and token silver currency is ordinarily provided by the State through the Central Bank. The value of silver is liable to

⁵ Kisch and Elkin, *Central Banks*, p. 114.

serious fluctuations and the Central Banks in practice may not deal in it.

Central Banks also deal in foreign exchanges. This is specially important in those cases where the currency of a country is linked to gold through the medium of some foreign currency which is freely convertible into gold and is also exportable in that form. In Germany and Belgium the notes may be redeemed at the option of the Banks "in gold or foreign currency representing the price of an equivalent amount of gold in the foreign country concerned, subject to a deduction corresponding to the cost of shipping gold thither from the home country."

In countries which have stabilized their foreign exchanges with reference to an external currency, the Central Banks have been given control over the foreign trade of their countries. The object is to enable the Bank to acquire foreign exchange, to influence import transactions involving a demand for foreign exchange and to check speculative dealings. This is the case in Poland, Italy, Bulgaria, etc. The Banks fix the exchange rates, and the purchases and sales of foreign exchanges on the part of the commercial banks are to be for real and justified requirements and are to be conducted through the Central Bank. These drastic powers are, however, impediments on trade and should not usually be adopted. The exchange stability should be secured by the Central Bank through its credit policy and not by direct intervention in foreign trade.

In cases of other Central Banks also which are under an obligation to issue gold on demand, foreign exchange dealings are permitted. This power is necessary for efficient Central Banking, and should not be exercised by the Bank purely for profit making purposes, but only in so far as it is essential for the due discharge of the duties of the Bank. The reason why Banks which have to provide gold should be allowed to deal in foreign exchange is to confine gold movements to marginal needs and to settle foreign obligations which cannot be adjusted in other ways. If bills payable in London or New York are remitted in payment exchanges can be kept within gold points. This power to deal in foreign exchanges enables a Central Bank to reduce exchange fluctuations to the minimum and to promote the stability of business and exchange and further, the use of gold can be economised. Discretion is necessary in the choice of foreign assets and in this connection the gain from interest on foreign holdings as compared with holdings of gold at home should not be the only consideration.

Bill discounting is another important function of a Central Bank. Continuously maturing bills should be kept by the Bank. A bill reveals to the expert the object of getting finance

and the Bank can distinguish between genuine and speculative needs. It is for a definite amount and has a definite date of maturity and, therefore, a Bank can regulate its purchases according to needs. At maturity it is bound to be paid with cash credits and advances. It bears many endorsements and becomes very secure and possesses the quality of free convertibility into cash.

A Central Bank should not rediscount all kinds of bills indiscriminately. The bills should be such as are drawn to obtain finance for genuine commercial purposes and should not be merely "finance" or "accommodation" bills. The former are self-liquidating as the sale of the commodity provides funds for paying the bill. The Bank should also rediscount Government securities of short currency as Treasury Bills presented by third parties, but there should be a limit on these operations as is the case with Central Banks in Belgium and Chile. If there is a legal limit to the power of the Bank to rediscount short-term government securities, the Bank is in a position to put pressure on a Government pursuing an improvident course of finance to return to sound practice. In the case of Japan the limit of rediscounting of Government securities by the Bank is decided every ten days by the Administrative Board of the Bank subject to the approval of the Minister of Finance. This governmental interference is not sound. This problem is treated at length in the Charter of the Bank of Greece.

As regards the maturity of bills, acceptances, etc., eligible for rediscount, the consideration of liquidity should be kept in view and only short-term paper should be rediscounted. The Bank Laws in various countries usually take a period of 90 days' maturity as making the paper eligible for rediscounting. In Italy, Sweden and America, the period is four, six and nine months respectively. In the latter case account is taken of the time necessary for harvesting and marketing of agricultural produce.

With regard to security, Central Banks usually require a minimum of two good signatures and in countries like Austria, Germany, Hungary, Belgium and Bulgaria three signatures are the minimum required according to Law. In many cases discretion is given to the management of the Bank to insist on a third signature or not. In some countries, England for example, rediscounting is possible only if the paper bears the endorsement of a bank of the country in question.

The principles applying to discount also apply to other loan operations of Central Banks. The advances should be generally for short periods and three months is the limit in case of most of the Central Banks and continuous and

indiscriminate renewals are avoided. Unsecured credits should not be granted by a Central Bank and for this reason the charters of most Central Banks define the classes of collateral as eligible for loans. The security should be readily saleable without loss in case it is to be redeemed. Precious metals, stock exchange securities, commercial bills payable in the home market and foreign currencies and bills payable elsewhere are the usual classes of collateral securities accepted by Central Banks.

Central Banks should not grant advances against merchandise a function which, properly speaking, falls within the sphere of commercial banks. Such advances are excluded under the Federal Reserve System and in the case of the Reserve Bank of South Africa, but are permitted by most of the European Central Banks (Kisch and Elkin, *Central Banks*, pp. 132, 133). As means of creating credit Central Banks should prefer rediscounting to loans and advances from the point of view of security, liquidity and negotiability and they should exercise their moral pressure to stimulate the creation of these credit instruments. Various modern charters contain provisions for promoting the use of bills and for creating credit against the alternative of advances against collateral securities. In case of the Central Banks of Austria, Hungary and Czechoslovakia the provision is that if the total loans of the Bank exceed the total bills held, the rate on advances is to be raised to one and a half times the discount rate.

As far as the deposit business is concerned, private deposits from the ordinary public should not be accepted by the Central Banks. Only the Federal Reserve Act definitely forbids this course and the South American Reserve Banks are allowed to receive such deposits. In any case interest on such deposits should not be paid by Central Banks, because if it is done, it will be an additional claim on the income of the Bank which may take risks in order to earn profits. The payment of interest to customers should, therefore, be prohibited. This is the case with the Reichsbank and the South African Reserve Bank. A Central Bank depositing funds at another Central Bank can, however, arrange with the latter for the remunerative employment of these deposits. This is not the same thing as interest payment on ordinary deposits. A Central Bank must maintain a sufficient proportion of its assets in a completely liquid state, but it does not follow that its total credits with a foreign Central Bank should not be remunerative.

A Central Bank should also provide facilities of currency and credit for the needs of internal trade and should also set up an expeditious and economical machinery for the clearance of drafts and settlement of internal accounts. A Central Bank holding the balances of commercial banks is specially

fitted for this task and arrangements for the settlement of debts by cheques drawn on the Central Bank by the member banks do exist in several countries.

A Central Bank should also regulate the supply of token currency which should be issued by the State through the Central Bank. Token coin should not be issued directly by the State as this might prejudice the position of the Central Bank as Currency Authority. There are provisions to this effect in the law governing the National Banks of Czechoslovakia and Bulgaria and also in the case of the Bank of Chile in a modified form.

If a Central Bank receives deposits from private customers, the latter will naturally look to it for carrying out financial and other transactions on their behalf which are usually carried on by commercial banks. This is not the business of a Central Bank, but if it is done, the Bank should not incur risk. It should not, for instance, purchase stock exchange securities for the private customers without having previously recovered the advance in respect thereof. The provision in the Reichsbank Law amounts to something like the above.

SPECIAL RESTRICTIONS ON THE BUSINESS OF A CENTRAL BANK

Restrictions must be imposed upon a Central Bank regarding its proper business in order to secure the maximum of safety and liquidity of its assets. The business that it is to carry on must be prescribed in unambiguous terms and in addition, it should be expressly debarred from carrying on any business that is inconsistent with its primary duties. This relieves the Bank of the risk of pressure to stretch its powers in a way that may be inconsistent with stability and its responsibilities as a Reserve Bank. The main restrictions should be as below :—

(1) The Central Bank should not accept any interest in a commercial undertaking and in South Africa, Bulgaria, Lithuania, Czechoslovakia, Belgium, etc., the Central Banks are debarred by their constitutions to have an interest in commercial undertakings. The National Bank of Bulgaria was required to free itself of commercial commitments and it was on this condition that the League of Nations was prepared to grant assistance for the rehabilitation of the finances of the country. If a Central Bank may on certain occasions be compelled to take over the commercial assets pledged by a borrower, the law should lay down that the Bank should sell such assets within a strictly limited period.

(2) A Central Bank should not hold freehold property because it is non-liquid and may have serious fluctuations

in its value. The Statutes in the cases of Germany, South Africa, Belgium, Poland, Chile and Czechoslovakia exclude freehold property from the category of permissible investments except if the property is required for the purposes of the Bank's operations.

(3) Ordinary commercial investments and long-term Government securities are also liable to depreciate and should not, therefore, be held as Bank's investments. Only short-term Government securities should be held by the Bank. The South African Reserve Bank, for instance, can deal without limit in Government securities of not more than six months' currency, but it cannot invest a sum exceeding its paid-up capital and reserve in Government securities of two years' maturity.

(4) No Central Bank should make unsecured loans or overdrafts and provisions to this effect exist in the constitutions of the Banks in South Africa, Bulgaria and Chile.

(5) A Central Bank should not lend money on the security of its own stock because in case of default by the borrower, the stocks will come to the Bank and it is virtually equivalent to the reduction of its capital.

(6) A Central Bank should not ordinarily borrow in the domestic market, because it can increase its cash assets and diminish the supply of funds in the market by selling securities and bills. It should also not have recourse to external borrowing to provide assets against which notes may be issued because foreign assets are balanced by a corresponding liability to repay in foreign currency. The use of external credits as a basis to create a further liability in the form of notes is consequently undesirable. The Bank of England and the Bank of France have on occasions borrowed money abroad, but this was with a view to provide the stability of currency. The Bank of England borrowed in America in 1925 and in America and France in 1931. But foreign borrowing for such purposes should be raised on behalf of the Government and the proceeds placed at the disposal of the Bank.

CO-OPERATION BETWEEN CENTRAL BANKS

The creation of a network of Central Banks opens the door to greater opportunities of rendering help to industry, trade and commerce. The Financial Commission of the Genoa Conference in 1922 stressed the importance of continuous co-operation between Central Banks which would not in any manner hamper the freedom of the various banks. Events since then have reinforced the necessity of co-operation and if there was ever a time for such concerted action on the part of Central Banks, it is now.

In recent years business relations have been established to an increasing extent between the Central Banks in Europe and America. A number of Central Banks keep accounts with other Central Banks to facilitate international payments between Governments in the form of debts and reparations. The Banks keep themselves in touch with market conditions and can make the transfers with the minimum of disturbance.

In the post-War period the demand for capital on the part of certain belligerent countries has exceeded the capacity of the internal markets and borrowings have been raised in foreign centres. These loans leave behind a burden of interest charges and sinking funds which, if not properly controlled, may become a danger to the currency standards of the borrowing countries and a breakdown in the credit of the borrowing country would destroy the confidence of the lending countries..

Gold movements and exchanges have effects not only on the discount policy in the internal markets, but also on that in the external markets and to avoid disturbances and breakdown constant consultation between Central Banks is necessary. Further, the progressive restoration of the gold standard in the post-War period was made possible to a large extent by the co-operation between Central Banks and an illustration of such a co-operation was furnished when a scheme was promoted for the rehabilitation of Belgian finance in which the Central Banks in England, France, Germany, Switzerland, the U.S.A. and Japan participated. The various schemes of currency reforms fostered by the League of Nations presupposed such an international co-operation between Central Banks.

A striking opportunity for international co-operation is offered by the practice recognized in various modern charters for treating foreign assets in stable foreign currencies as equal to gold. These assets serve the basis of and a cover for note issue. This is the case with the Bank Charters in Austria, Hungary, Belgium, etc. These countries have a direct interest in the stability of the foreign currencies which they have recognized as a cover for their own note issues and this has also placed a very serious responsibility upon those foreign countries whose assets have been treated as cover. The credit policy in both classes of countries has to be conducted on safe and sound lines which presupposes co-operation between their Central Banks.

The smooth working of the gold standard was entrusted to Central Banks which could regulate the monetary demand for gold in accordance with the available supplies without forcing a serious departure from the existing level of gold prices. It was expected that they would refrain from engaging in a scramble for gold which would not

be in the best interests of any country. This expectation has not been fulfilled and there has recently been a great scramble for gold forcing most of the countries off the gold standard. The Gold Delegation of the Financial Committee of the League of Nations have in their final report pointed out that the breakdown of the gold standard has been mainly due to this scramble for gold and they have stressed the necessity of a return to the gold standard. This requires the raising of the price level and concerted action on the part of Central Banks is exceedingly necessary. The present economic ills of the world are largely the result of currency and monetary disturbances and the situation can be changed for the better only if the Central Banks backed up by the respective governments of their countries show a spirit of harmonious co-operation. This has so far not been coming and a very striking proof of this fact is the failure of the World Economic Conference which had raised high expectations in the minds of people.

CHAPTER XX

American Banking System

PRIOR to 1914, the United States of America furnished the most important example of a decentralized banking system ; but the Federal Reserve Act which was passed in 1913 and put into operation in 1914 changed the system into one which can partly be called as centralized and partly decentralized. We shall begin first by describing the system as it existed prior to the passing of the Federal Reserve Act in 1913 and by pointing out its defects and then we shall describe the new arrangements made under the Act.

There were in 1912 approximately 30,000 banking establishments of which about 28,000 were banks whose business was wholly or partly of a commercial character. Their business was chiefly local in character and they were mostly owned by the residents of the communities in which they were located and there was little association except among the big banks through the clearing house organization. Being without effective leadership, the banks did by no means work in co-operation the dangers of which were very serious specially in times of threatened panics.

The defects of the old banking system may be conveniently grouped under four heads : (1) decentralization of reserves, (2) inelasticity of credit, (3) defective exchange and transfer system, and (4) defective organization as regards relationship with federal treasury.

(1) *Scattered Reserves.*—The most serious feature of the system was the scattering of reserves. All these banks kept separate cash reserves of their own upon which they depended in times of necessity, and these reserves were very substantial in amounts. In addition to the cash in their vaults, most of these banks had deposited reserves with other banks which they could count as part of their legal reserves and they also had secondary reserves, *i.e.*, funds invested in securities and call loans which were supposed to be very quickly realizable in times of need. In reality only the cash reserves were real reserves in the sense that they could be serviceable in times of a run on the bank. The deposited reserve was merely a deposit in some other bank which the depository bank commonly loaned out on the stock exchange and against which it held its own reserve. Thus the deposited and secondary reserves could be called back only to the extent that the stock

exchange securities could be sold which was by no means an easy matter in times of panics. They could be sold only at greatly reduced prices which meant heavy losses. Thus in times of danger only the banks' own cash reserves could be counted as solid means of support and, therefore, they had to be maintained at a very high level.

Further, each bank guarded its own reserves very jealously in times of panic and did not come to the rescue of other banks. In aggregate these reserves were very large, but being scattered and immobile they were absolutely ineffective in allaying the panic. To be effective, a country's reserves should be concentrated mainly in one reserve or in a few central reserves. This was not the case in America then and there was no effective way of quickly bringing them together to meet the situation.

(2) *Inelasticity of Credit.*—Another set of defects in the old banking organization was the inelasticity of her credit mechanism. In a country like the U.S.A. where agriculture is an important industry, there are very important seasonal fluctuations in the amount of money required. A good banking system is one which has got the capacity to adjust the supply of its deposit currency and of bank notes to changes in the demands of trade and commerce. It must be able to increase the currency when more of it is required and must be equally capable of contracting currency when the demand decreases. Judged from this point of view also, the old American banking system was very inefficient.

The national banks were allowed to issue notes on the security of government bonds. But they could not issue notes for a larger amount than the par value of the bonds. More notes could be issued by purchasing government bonds of the same amount. The note issue could not be increased without investing an equivalent sum of money in government bonds. But when business was brisk and the demand for money was great, the bonds were sold at a premium and the banks had to pay this premium which wiped out large profits on the note issue. Consequently, the banks issued more notes when the bonds could be purchased at par or below par which was generally the case when demand for money was slack and currency was already in abundance. Thus the expansion and contraction of the bank note circulation was not as it should have been in response to trade demands, but it was in response to the price of government bonds. As the prices of the bonds rose when there was an increase in the demand for currency, the banks avoided purchasing them and the currency in circulation did not increase adequately. The prices of the bonds on the other hand declined when business was slack and

the currency was already abundant. The banks purchased bonds at such times and issued more notes. Thus there was a sort of inverse elasticity and the bank note circulation could not cope with the situation.

The deposit credit was also equally inelastic. The Central Reserve and the Reserve City Banks were under a legal obligation to keep a reserve of 25 per cent. in gold against their deposit obligations subject to cheques and the country banks had to keep a reserve of 15 percent. against their demand obligations subject to cheques. In times of increasing business activity, the banks could not grant loans to their regular customers and could not create deposits by discounting commercial paper because they had to keep the minimum legal reserve. The rediscounting business was almost negligible and there was no central institution to do this business for the banks.

As a result of the credit inelasticity, there were very wide and frequent fluctuations in the rate of interest for short-term loans and the American money market was notorious for this state of affairs. The businessmen and the farmers suffered very much for this rigidity of the credit system. The farmers suffered a great deal of loss because they had to sell their staple crops largely at a time of falling prices owing to the money market being tight and also because they had to purchase their supplies at a time when prices were high on account of the money market being easy.

(3) *Defective Exchange and Transfer System.*—Another group of defects in the old American banking system lay in certain cumbersome features in the domestic and foreign mechanism of exchange. With regard to domestic mechanism, it may be said that money was transferred by sending cheques to different and remote places and most of the clearing houses imposed charges for collection, but others did not impose any charges and, therefore, a practice grew up to send the cheques through round-about and circuitous routes to avoid clearing charges. One serious defect of this practice was the padding up of legal reserves. The competition among the large city banks being very keen for the accounts of the country banks, the former allowed the latter an immediate credit for these out-of-town cheques. But these cheques were collected by the city banks after a number of days. The country banks, however, counted them as their legal reserves with the city banks as soon as these cheques were sent by mail. The Reserve City Banks sent some of these cheques to the Central Reserve City Banks and counted them as Reserves as soon as they were mailed. Thus the same cheque served as reserve at two or three

different banks and probably in the end was returned without being honoured by the drawee banker.

A second defect of the domestic exchange was the trouble and expense incurred in sending money from one place to another for paying these cheques. The seasonal demands arising at different times in different places were responsible for sending the shipments of specie to and fro which meant much unnecessary expense.

Besides, there were foreign exchange difficulties also. The American foreign trade before the War and specially that with the Orient and South America was largely financed through the English money market. This excessive dependence upon the London money market was disadvantageous from the point of view of America in two ways. Firstly, it gave rise to an additional foreign exchange operation which implied greater expenditure and risk and secondly, the sending of the documentary drafts through foreign banks gave them an insight into the state of the foreign business of America—information which was taken advantage of by America's competitors.

RE-APPORTIONMENT OF THE TREASURY FUNDS BETWEEN SUB-TREASURIES AND BANKS.

The funds of the Treasury were partly kept in nine sub-treasuries and partly in some of the national banks. The task of apportioning these funds between the sub-treasuries and the banks and among the banks was entrusted to the Secretary of the Treasury. This system was defective in four important respects: (1) Large sums of money were hoarded in the treasury which involved large amounts of administrative expenses. (2) At the time of receipts from income-taxes, etc., large funds were withdrawn from circulation which involved a contraction of currency; but at other times the disbursements exceeded receipts when there was a sudden increase of money into circulation. This state of affairs brought about wide fluctuations in the interest rates on call loans and in the prices of speculative securities. (3) The task of apportioning these funds between the sub-treasuries and the banks on the one hand and among the national banks on the other, placed a great power in the hands of the Secretary of the Treasury. Thus the control and power of the government official over the money market were very great—a task for which he was not well suited. (4) The various depository banks relied too much upon the Secretary of the Treasury for help in the form of government deposits in times of emergency and financial pressure.

To remove the above-mentioned defects, the Federal Reserve Act was passed on December 23, 1913, which actually

came into operation in the November of 1914, when the Federal Reserve Banks opened their doors for business. The Federal Reserve Act did not destroy the independence of the small banks, but federated them into one unified system.

We shall now study the plan of organization under the new system to see how the defects of the old system were remedied. The whole country was divided into twelve Federal Reserve Districts and one Federal Reserve Bank was created to serve one district. All the national banks were made to join the system and facilities were also given to State institutions and the trust companies to induce them to join the system. The Federal Reserve Banks are bankers' banks and their capital stock is owned only by banks and by individuals. All the member banks in a Federal Reserve district are required to subscribe to the capital stock of the Federal Reserve Bank of their district to an amount equal to six per cent. of their capital and Reserve Fund.

All the member banks of a Federal Reserve Bank are divided into three classes according to their capital. They may be called group A banks, group B banks and group C banks. Each group has nearly an equal number of banks. Each group elects two directors, on the basis of 'the one bank, one vote principle'. One of these directors represents the stock-holding banks and the other the business community. Three directors are appointed by the Federal Reserve authorities at Washington to represent the government and the general public. One of these directors appointed by the Federal Reserve Board is the chairman of the Board and is known as the Federal Reserve Agent. The Board thus consists of nine members each holding office for three years and the Board is representative of all interests among the public. This Board is the governing body of the Federal Reserve Banks.

All these 12 banks are under the control of a Central Board at Washington known as the Federal Reserve Board. It consists of eight members, two of whom being the Secretary of the Treasury and the Controller of the Currency who are *ex-officio* members. Six members are appointed by the President of the U.S.A. with the consent of the Senate. These six members represent the financial, agricultural, commercial and industrial interests of the country. The Secretary of the Treasury is the Chairman of the Board.

This Board is assisted by a Federal Advisory Council of 12 members, one member being appointed by each Federal Reserve Bank. In this way administrative centralization is secured without depriving the country of the benefits of independent banking units. The Federal Reserve Board is the directing head of the system and has large powers. In this

way all the 12 banks are federated together. This coupled with the proviso that the Federal Reserve Board appoints three of the nine directors of each Federal Reserve Bank and the latter appoint the 12 members of the Advisory Council secures the utmost unity of purpose.

One of the defects of the old system was the lack of centralization of reserves. Under the new system reserves were concentrated with the Federal Reserve District Banks. All the member banks were required within a certain period of time to keep their legal reserves with the Federal Reserve Bank of their district and to withdraw their deposited legal reserves from the banks of Reserve and Central Reserve cities. The member banks may keep as little or as much cash on hand for till money as they wish and may keep their balances with other banks if they like ; but their legal reserves must be kept on deposit in Federal Reserve Banks. Further, the percentage of reserves against demand deposits was reduced from 25 per cent. and 15 per cent. to 13 per cent., 10 per cent. and 7 per cent., in case of Central Reserve City Banks, Reserve City Banks and County Banks and to 3 in case of time deposits. The Federal Reserve Banks do not keep all this in their vaults but invest it in short-term loans. By law, they are required to keep 35 per cent. against deposits.

These Reserves concentrated at a few places create confidence among the people that the latter can have money on demand. This confidence will induce them to leave their deposits with banks because they know that they can get cash whenever they like. In addition to centralization, mobility of reserves is an important quality and the Federal Reserve System has created machinery for achieving this object also. The mobility of reserve money was increased by the Federal Reserve Law in three ways. Firstly, money could be transferred from one place to another through the rediscounting device. Formerly, banks did not come to the rescue of each other and held their reserves tight in emergency ; but the Federal Reserve Act authorized the Federal Reserve Board to permit and even compel a Federal Reserve Bank having high reserves and low demands to rediscount the commercial paper of other Federal Reserve Banks where demand was exceptionally heavy at reasonable charges. This means a transference of money from the reserves of the former banks to those of the latter. Secondly, money could be transferred from places of redundancy to places of scarcity through open market operations. The Federal Reserve Banks were authorized to have dealings with outside public as well in addition to having dealings with their members which were banks only. These dealings were allowed with a two-fold object, *viz.*, to make the discount rates of the Federal Reserve Banks effective and to

allow these Federal Reserve Banks to profitably employ their funds when members made few calls upon them. These dealings with the outside public are known as open market operations. The Federal Reserve Banks could purchase or sell in the open market bills of exchange, bank acceptances, and other commercial paper. Such dealings would cause a flow of reserve money from the district of the buyer to the district of the seller for the former had to remit money to the latter. Finally, a broader discount market for commercial paper, e.g., trade acceptances and bank acceptances was sought to be created. The seller of the goods could take the purchaser's or his banker's acceptance in payment of his goods and get it discounted at his own bank or with other banks in the market. Such commercial paper would flow from places of high discount rates to those where they were relatively low and money, therefore, would flow from the latter to the former places. In these various ways mobility of funds from places of redundancy to places of scarcity was secured.

Credit elasticity under the new system increased both with regard to note issue and deposits subject to cheques. A noteworthy feature of this Act was the creation of an additional form of note currency secured by first class commercial paper. There were three classes of note issue: (1) *The National Bank Bond Secured Notes*—These were the notes issued formerly by the National Banks and for which the U.S.A. Government Bonds of equal face value were held as security. It was at one time suggested to eliminate them completely, but this would have meant a great and sudden contraction of currency and also a loss to the banks as the value of the bonds which they were holding would have fallen very much. Hence their retirement was to be affected gradually. (2) *Federal Reserve Bank Notes*—They were merely bank notes of the old type issued by the Federal Reserve Banks instead of by the national banks and they were secured by a specific deposit with the United States Treasury of bonds or of certain short-time obligations of the government. They began to have increasing importance after they replaced the silver certificates and silver dollars in circulation. But since 1920, they began to be replaced by silver certificates, for the government again began to repurchase silver from that year. (3) *Federal Reserve Notes*—It is these notes upon which the reserve system places its sole reliance for bank note elasticity. They provide absolute elasticity, for they are issued on the strength of commercial paper. If member banks of any section require an increased supply of currency to meet local demands, they can rediscount eligible paper with their Federal Reserve Bank and take the proceeds minus discount in Federal Reserve notes. If the Federal Reserve Bank has not got a sufficient supply of these notes,

it can deposit the rediscounted paper with the Agent and obtain an additional supply of these notes. So long as eligible paper is available, an additional quantity of these notes can be secured. But these banks must have normally a legal gold reserve of 40 per cent. of the face value of these notes in order to ensure their convertibility and to prevent over-issue. In times of emergency, however, to secure elasticity the amount of this legal reserve can be allowed to fall below 40 per cent., provided the Federal Reserve Board gives its permission and imposes a graduated tax upon the amount of the deficiency. In addition to this, to meet extreme emergencies the Board has the authority to dispense with for a period of 30 days and to renew such suspensions for a maximum of 15 days from time to time any reserve requirement specified by the Act. Thus the quality of expansibility of their volume is ample.

The power of contractibility also is equally effective. Where the demand for surplus notes falls, they will be deposited by the public in their banks but they have to be sent by the banks to their banks of issue. No Federal Reserve Bank can pay out notes issued through another under penalty of a tax of 10 per cent. upon the face value of notes so paid out. Further, the Federal Reserve Board has the authority to charge such a rate of interest as it thinks proper on Federal Reserve notes which are not covered by gold or gold certificates. These two devices ensure the contractibility of the surplus note circulation. They are not legal tender and this fact is also responsible to some extent for the retirement of the Federal Reserve notes when they become redundant.

The elasticity of deposit currency also was very much enhanced under the new system. The old rigid legal requirements were dispensed with and much less rigid ones were inserted in their place. The national banks may keep as little or as much as they like in their vaults, but they must keep their legal reserves deposited with the Federal Reserve Bank of their District. The latter were to keep 35 per cent. against their deposits; but in emergency times, they might not keep even this 35 per cent. provided they paid a graduated tax upon the amounts by which the reserve requirements against deposits were permitted to fall below the level of 35 per cent. Such loans would be costly to the lending bank and the borrower as well and, therefore, only genuine transactions would be financed with their help.

The most important device under the new system for securing the elasticity of deposit as well as bank note currency lay in the way in which loans could be granted to member banks by their Federal Reserve Bank. Funds so borrowed were to be left with the Federal Reserve Bank to serve as legal money

for the member banks. Generally speaking, these loans made by the Federal Reserve Banks to their member banks are of two types, rediscounts and loans on collateral. Such provisions were inserted in the Act which permitted the rediscounting of only the first class commercial paper. The paper must not be for long periods and must be based on genuine mercantile transactions. Collateral loans are loans granted by the Federal Reserve Banks to their member banks on the security of the latter's collateral notes, *e.g.*, notes, drafts, bills of exchange, bank's acceptances and bonds or notes of the U.S.A., etc., and these collateral notes must not exceed 15 days. This device was to grant short-time loans to member banks when the latter were reluctant to rediscount their customers' notes for the purpose. The contraction of deposit currency was ensured by the pressure of high discount rates and of the graduated tax. This coupled with the stringent conditions placed by the Federal Reserve authorities on rediscounting when market was easy, would bring out the necessary contraction of deposit currency. But, of course, a great responsibility lay on the Federal Reserve Board in this respect.

The domestic and foreign exchange business also under the new arrangement improved to a great extent. When the country banks could not count as legal reserve the money deposited by the latter with the former, they would not keep it there. The city banks which used to collect the cheques of the country banks would not collect them now and moreover they would compete with the country banks for some of their very profitable business. Obviously, if the new Federal Reserve Banks were to displace the city banks as the holders of the country banks' deposited reserves, they should also perform for the country banks the service of collecting or clearing their out of town cheques. Under the new system the clearing and collecting of cheques of their member banks and of such non-member banks as were members of the clearing system would be done by the Federal Reserve Banks. The law requires the Federal Reserve Banks to "receive on deposit at par from member banks or from Federal Reserve Banks cheques and drafts drawn upon any of its depositors, and when remitted by a Federal Reserve Bank, cheques and drafts drawn by any depositor in any other Federal Reserve Bank or member bank upon funds to the credit of the said depositor in the said reserve bank or member bank."

Thus every Federal Reserve Bank performs the functions of a clearing house in its district for member banks and qualified non-member banks known as clearing member banks. It must receive at par from such banks cheques drawn on all other member and clearing member banks and such non-member banks who agree to remit at par cheques through their Federal

Reserve Bank. All banks belonging to the clearing system must pay at par cheques drawn upon themselves when presented through a Federal Reserve Bank. The cost of collecting and clearing cheques for member and clearing member banks is borne by the Federal Reserve Banks. As a compensation they may require their customers to carry larger balances or they may treat this expense as a sort of advertisement.

Under the old system there was another difficulty of sending shipments of specie to and fro as required by seasonal demands. Under the new arrangement, a large proportion of currency shipments is avoided by the creation of the Gold Settlement Fund and the Federal Reserve Agents' Fund. Every Federal Reserve Bank has to deposit with the Treasury or the nearest sub-treasury of the U.S.A. for credit to the Gold Settlement Fund at least \$1,000,000 in gold and in addition an amount at least equal to its indebtedness to other Federal Reserve Banks. The amount so deposited at Treasury of the U.S.A. constitutes the Gold Settlement Fund. This counts as the Federal Reserve Banks' legal reserve also. The settlement of balances between Federal Reserve Banks is daily affected by making transfers in the form of book entries in the books of the gold settlement fund. The information regarding transfers is sent by telegrams, etc. Each Federal Reserve Agent has large funds in his custody representing gold pledged with him as security for Federal Reserve Notes. This Fund is known as the Federal Reserve Agents' Fund which is also used for off-setting cross obligations among all the Federal Reserve Banks, and between any Federal Reserve Bank and the U.S.A. Treasury. "By means of the Gold Settlement Fund and of the other transfer facilities of the Federal Reserve Banks, these banks are now enabled to make telegraphic transfers of funds to any part of the United States for their members without any charge. They have also inaugurated a system of Federal Reserve Exchange drafts, according to which a member bank may draw special drafts on its Federal Reserve Bank for amounts not exceeding 5,000 which are receivable for immediate availability at any other Federal Reserve Bank."

Foreign Exchanges.—The Federal Reserve Act brought about important modifications for financing America's foreign trade also. The War upset the money markets of Europe and, therefore, there was a great need for American funds on the part of foreign nations. The foreign trade which was formerly financed by other nations through letters of credit under which sterling bills were drawn began largely to be financed by bills of exchange drawn in dollars upon banks and business houses in the U.S.A. There is a ready market for the sale and rediscount

of commercial paper drawn in connection with American foreign trade. Bank acceptances were legalised in connection with foreign trade and foreign exporters can draw bills of exchange upon the American importers' banks. The Federal Reserve Banks also established agencies abroad and facilities were given to foreign importers also who could open credits with American banks upon which American exporters would draw bills of exchange which after being accepted by the American banks could be sold in the discount market in America. Further the Edge Amendment of 1919 authorized the organization of corporations to engage in international or foreign banking or other financial operations. These corporations operate under the supervision of the Federal Reserve Board and it is open to the national banks to purchase the stocks of these corporations subject to the provision that such investment should not exceed 10 per cent. of the national banks' capital and reserve fund. Such corporations are not allowed to carry on any part of their business in the U.S.A. except such as in the Federal Reserve Board's opinion may be necessary for their foreign or international business. As a result of the War and of the changes introduced by the Federal Reserve Act in the American Banking system, America is financing directly a large proportion of her foreign trade.

The defective organization of the old system from the point of view of the Treasury was done away with by the passing of the Federal Reserve Law. The law provided that the general funds of the Treasury, except the five per cent. fund for the redemption of national bank notes and the funds for the redemption of Federal Reserve notes could be deposited in Federal Reserve Banks upon the discretion of the secretary of the Treasury and the Banks were to act as fiscal agents of the United States Government for receiving revenue receipts and paying cheques drawn by the latter.

The Secretary of the Treasury could keep general funds with the Federal Reserve Banks, the member banks and the sub-treasuries (which were abolished in 1921) as he liked. But the member banks could get these funds through their Federal Reserve Banks upon whom they could put forward their claims. This took away the vast responsibility from the Secretary of the Treasury of apportioning the funds among thousands of banks. The Federal Reserve Banks would also be in a better position to know the needs of the various member banks than the Secretary of the Treasury and would be able to conserve the strength of the money market by making its rediscount rates effective; for the member banks could get their funds through the rediscount process. The bank rate obviously could not have been effective if the member banks could get

funds directly from the Secretary of the Treasury and neglect the Federal Reserve Banks and the Federal Reserve Board.

During the war time the government could not discontinue the policy of making individual banks as depositories of government funds, because this would have disturbed the money market conditions. Even when the Liberty Bonds were floated when America entered the Great War the government wisely adopted the policy of keeping these funds widely scattered in the banks of the communities where they were received.

Government deposits were kept as nearly as possible in the places where the funds were received by the government. But the work of handling these funds was entrusted to the Federal Reserve Banks—a duty which they discharged admirably. "These banks were asked to select the banks that were to handle the government funds, to allot deposits to the banks in proper amounts, to examine the collateral, that such banks offered....to withdraw funds from the bank as they were needed by the government."

The government followed a number of devices to prevent disturbances in the American money market. Firstly, income-tax receipts in the form of cash, cheques and certificates of indebtedness were sent to the Federal Reserve Bank of the District from which they were received. The District Bank after sorting the cheques sent them to the same bank to be deposited upon which they were drawn.

A second device was to issue certificates of indebtedness which were short-time government loans bearing low rates of interest. They were paid off when the receipts of the Liberty Bonds came to the government. The object of issuing these certificates in anticipation of Liberty Bonds was a two-fold one. The government required money promptly which it could raise through these certificates. But it took time to get money on Liberty Bonds. Further, by this means the government succeeded in preventing Liberty Bond sales from disturbing the money market, because it put into circulation money by paying off the certificates at the same time that it withdrew funds from circulation through Liberty Bonds. The sale of the certificates was another task entrusted to the Federal Reserve Banks as was that of floating the Liberty Bonds. The Federal Reserve Banks also granted overdrafts to the government in times of pressure.

The Federal Reserve Banks did much during the Great War. It would have been extremely difficult if not impossible to carry through the financial operations under the old American banking system. "One shudders when he thinks what

might have happened if the war had found us with our former decentralized and antiquated banking system. Think of pouring the crisis of 1914-18 into bottles that broke with the crisis of 1907!"

CHAPTER XXI

Recent American Banking Crisis

THE American banking system collapsed in the first quarter of 1933 which gave a rude shock to public confidence. This was contemporaneous with the financial crisis in the world which passed through its worst phase between May 1931 and June 1932. The banking systems of many countries had been very adversely affected by the crisis and were working with greatly reduced volume of business. They were suffering from many dangerous legacies of the crisis as frozen assets and heavy investment losses. It will be true to say that "most of them had come through an unprecedented period of stress, damaged, perhaps, but not destroyed. In the first quarter of 1933, however, the collapse of the United States banking system struck a fresh blow at public confidence."¹

The main causes of this banking crisis in the U.S.A. lay partly in the structural organization of her banking system and partly in the general credit expansion which took place from 1922 to 1929. It will, therefore, be correct to say that one of the most important causes of the crisis was a weakness in the structural organization of the banking system. A large number of small, local banks grew up in the country in response to the needs of their immediate constituencies, but they were not fully integrated into any general financial system. In 1921 there were 29,211 banks in operation and the number had steadily fallen to 23,972 by June 1929 and to about 17,000 by June 1932. In 1929, 22 per cent. of the banks had a capital stock of less than twenty-five thousand dollars and 84 per cent. had less than one hundred thousand dollars; but the total banking resources of these 84 per cent. were less than 40 per cent. The 250 largest banks constituted about one per cent. of the total number and controlled more than 50 per cent. of the resources.

It will thus be seen that the period of consolidation and co-ordination had begun long before the depression, but it had not reached the point where a fully developed central bank could support and control the numerous scattered commercial banks, or where the stronger commercial banks had developed the tendency, so pronounced in other countries, to incorporate the smaller banks as branch units of the larger organization. Branch banking had not developed to a great

¹ League of Nations, *World Economic Survey*, 1932-33, pp. 235, 236.

extent because of legal difficulties and diversity of State regulations. There was a great competitive element in legislative and administrative control under which State and National Banks worked and the possibility of developing a co-ordinated and consolidated financial system was retarded by the facilities of incorporation under State laws. Though the Federal Reserve System performed many functions of a central bank, it did not comprehend all the commercial banks under its control. Undoubtedly, it did bring some measure of co-ordination into the system and linked the smaller with the larger banks and, therefore, introduced a certain measure of elasticity of resources into the system.²

Another important cause was the considerable expansion of credit from 1922 to 1929, in the course of which important changes took place which had impaired the liquidity and solvency of many banks when the stock exchange boom collapsed in 1929. This credit expansion was caused by the great influx of gold into the banking reserves during the years 1922 to 1929.³ The gold influx was reinforced by increased currency issues as silver certificates and by the liberal rediscount policy pursued by the Federal Reserve Banks.

The banking methods adopted to maximise the expansion of advances and deposits based upon the newly acquired reserves were also responsible for increased business activity. These banking methods have been described in the *World Economic Survey for 1932-33* as below :—

"Without entering into the technical details of these methods, they may be rather summarily described as devices to finance the expansion of foreign business, municipal lending, and the security and real estate speculation that developed rapidly in this period. The practice of building up time rather than demand deposits in order to take advantage of the lower reserve requirements exacted in respect of the former, the creation of security affiliates to promote the flotation and marketing of new stock issues, the practice of granting liberal advances upon industrial securities and real estate collateral, thus facilitating the financing and refinancing of industry by direct issues of new shares on the market instead of by overdrafts or commercial bills, and the provision of large loans to security brokers were some of the ways in which banking practice facilitated the security and real estate boom." (Pages 237 and 238.)

² For statistical details regarding the organization of the banking system in U.S.A., see *League of Nations Commercial Banks, 1913-1929*, Geneva, 1930, and *Commercial Banks, 1929-32*, Geneva, 1933.

³ See the *Report of the Gold Delegation of the Financial Committee of the League of Nations*, Geneva, 1932, pp. 35, 37 and 66. Also *World Economic Survey, 1932-33*, p. 237. *

The following table shows clearly the changes in the banking practice in the U.S.A. in 1922 and 1929⁴ :—

Loans and Investments of Commercial Banks in the United States, 1922-1929.
(\\$ 000,000's)

| Class of credit | June 30th, 1922 | June 30th, 1929 | Increase | |
|----------------------|--------------------|--------------------|----------|-----------|
| | | | Amount | Per cent. |
| Security loans .. | 6,521 | 11,518 | 4,997 | 77 |
| Real estate loans .. | 1,989 | 4,540 | 2,551 | 128 |
| All other loans .. | 15,194 | 18,567 | 3,373 | 22 |
| Investments .. | 9,215 | 13,191 | 3,976 | 43 |

It will thus be seen that for liquidity the banks depended more and more upon the stability of the security and real estate markets. The amount of self-liquidating commercial bills and government securities in the banks' portfolios declined very much as compared with the amount of loans on real estate, industrial securities and municipal advances. Owing to the reduced proportion of commercial bills and government securities in the portfolios of the banks, their capacity for getting rediscounting facilities from the Federal Reserve Banks fell very much. 'The increased proportion of their assets which took the form of direct investments was another source of illiquidity.' It means that the banks lent heavily against securities which could not be easily turned into cash without heavy loss. When the security boom collapsed in October 1929, the capacity of the banks to meet the demands of their depositors was heavily impaired.

The heavy fall of security prices and of real estate created great difficulties for commercial banks. They had to overhaul their portfolios, restrict advances and to call for additional collateral. When it was not forthcoming, they had to sell the collateral already in their possession. As the collateral was released into the market at a rapid pace its price fell considerably. The banks thus tried to regain their lost liquidity by drastic curtailment of credit and tightening up of advances. These deflationary processes restricted business and reduced purchasing power considerably. It was this long deflationary process which brought about the crisis of 1933.

There were four periods through which this liquidation process passed. The first period remained from October 1929

* See *The World Economic Survey, 1932-33*, p. 238.

to May 1931. During this period, the liquidation was slow and moderate. Loans and investments during this period declined by less than 7 per cent. Discount rates were lowered and the Federal Reserve Banks increased the credit basis for commercial banks by their open market policy, *i.e.*, by purchasing government securities and by thus facilitating a reduction in the indebtedness of the member banks to themselves. This indebtedness was in this manner reduced from 1,000 million dollars in August 1929 to 250 million dollars in June 1930. The commercial banks could sell their securities and pay off their debts. Thus free lending at cheap rates and open market purchases were designed to relieve the commercial banks, but they did not prove adequate.

The new phase of the crisis began in May 1931 with the banking difficulties of the Austrian Credit-Anstalt which precipitated an international financial crisis. The difficulties of this period continued up to June 1932. During this period deflation took a sharper turn in the U.S.A., and in September 1931 when U.K. and other countries left the gold standard, the pressure developed into the "liquidity crisis".⁵

There was a large number of bank failures and the mortality was greatest among the smaller banks which were not members of the Federal Reserve System. Other factors which placed a heavy strain upon the banking system were gold and currency hoarding which became intensified in the second half of 1931. By the end of June 1932, the amount of currency hoarded in the United States amounted to at least 1,600 million dollars.

Foreign short-term credit was heavily withdrawn and gold exports increased considerably. There was a reduction of American short-term assets abroad. European banks strengthened their domestic position by withdrawing their short-term assets principally from New York. The total monetary stock of gold of the U.S.A. declined by 1,100 million dollars between the period ending June 1931 and June 1932.

There were drains upon the banking reserves also which are the heart of the credit system. This involved drastic deflation. The banks were compelled to reduce their advances and as the margins of security fell, collateral holdings were thrown upon the markets and prices of securities fell heavily. 'By the end of June 1932, commodity prices, security values, industrial production and employment had touched new low records for the depression and remained at levels lower than any experienced since the War.' During the twelve months

⁵ For details, see *World Economic Survey for 1931-32*, Pp. 211-219.

ending June 30th, 1932, the total loans and investments of member banks were reduced by 17 per cent., *i.e.*, by 6,000 million dollars. There was a deflation of security loans and of security values. The investments of the banks were subjected to heavy losses and the total losses sustained by American banks on their bond holdings amounted to at least 2,000 million dollars or equal to half the paid-up capital of the American banks in existence in June 1931. There was a great pressure upon the cash basis of bank credit owing to a number of difficulties. Municipal advances were strained, there was domestic hoarding, the withdrawals of short-term balances increased and security prices and real estate values fell considerably. The Government and the Federal Reserve Banks put emergency measures to meet the situation. These measures took three principal forms.

Firstly, in the early stages, the Federal Reserve Banks increased rediscounting facilities to the member banks and later on, they began to buy government securities once more on a great scale in the open market to enable the member banks to repay their indebtedness. Between the end of February and the end of June 1932, the Federal Reserve Banks' holdings of government securities increased from 740 million dollars to 1,784 million dollars.

The National Credit Corporation was formed in October 1931 by the co-operation of several large banks to grant credit to banks in temporary difficulties. This measure restored confidence temporarily, but troubles revived in December and January. Thus in February 1932 the Reconstruction Finance Corporation was organized and took over the business of the National Credit Corporation. Its capital stock amounting to 500 million dollars was entirely subscribed by the Government, which also purchased 825 million dollars of 3½ per cent. notes from the Corporation. The necessary funds were raised by issuing bonds and Treasury Bills which were purchased largely by the Federal Reserve Banks. With this capital the Reconstruction Finance Corporation advanced huge sums of money principally to banks, trust companies, railways and insurance companies. At the end of June 1932, these loans amounted to over a billion dollars. The object was primarily to enable solvent institutions to survive the panic phase of the crisis.

The third line of defence was by legislation. The Glass-Steagall Act was passed in March 1932 with the object of giving greater powers to the Federal Reserve Banks in the creation of credit. The open market operations of the Federal Reserve Banks required a very large amount of "free gold" and this new Act authorized them to use Government securities

in addition to "eligible paper" and gold or gold certificates as collateral for the note issue. In this way the free gold holdings of the banks were increased and a larger element of elasticity was introduced into the banking system.

The notes of National Banks were also given a wider basis of cover by legislation. The Emergency Relief Act of July 1932 also extended the powers of Federal Reserve Banks to make advances to individuals and corporations, but these advances could formerly be made only to member banks.

The second half of 1932 was a period of comparative tranquillity as a result of greater elasticity to the banking system, of the cheaper credit policy of the Federal Reserve Banks and of the provision of Government loans through the Reconstruction Finance Corporation.

There was a recrudescence of the trouble towards the end of 1932 and the crisis entered its fourth phase. Bank failures began to increase. There was a wave of mistrust and withdrawals of deposits took place in large amounts. There were runs upon banks. 'This panic was the most spectacular breakdown of public confidence witnessed in any country for many years.' In February, there were runs on important banks in the State of Michigan and all banks in the State were closed for a week. In other parts of the country confidence failed very rapidly and similar runs and banking holidays occurred in other States also. On March 4, the day of his accession to power, President Roosevelt, faced with this situation, declared a national banking moratorium.

The extent of the strain on the banks may be noticed from the fact that between February 1st and March 8th, the monetary circulation increased from 5,652 million dollars to 7,538 million dollars, an increase to the extent of 455 million dollars taking place on one day, March 3rd. The drain began in the interior, but the country banks drew heavily on their New York correspondents. The reserves of the Federal Reserve Banks despite the legislation mentioned above were brought down by gold export and hoarding very near the minimum reserve ratio. The ratio of the New York Bank fell to 41.4 per cent. and it was kept above the legal minimum of 40 per cent. only by selling Government securities to, and rediscounting the Bank's own paper with, other Federal Reserve Banks. The ratio for all the Federal Reserve Banks fell to 45.1 per cent.

The President on March 4th proclaimed a national bank holiday and imposed an embargo upon the export of gold and silver. The Federal Reserve Banks were instructed to pay no more gold or gold certificates and to prepare a list of gold holders. The Congress, at its special session, approved emergency measures giving the President complete control over all

the banks, authorizing the reopening of the banks declared to be sound and the reorganization of others. The Federal Reserve Act was amended to give greater powers to banks in regard to note issue and advances.

The gold standard was abandoned on April 19th and consequently a definite upward movement took place in loans and investments. On June 16th, the Banking Act of 1933 was signed. A Federal Deposit Insurance Corporation was set up in order to guarantee deposit accounts. Greater powers were conferred upon the Federal Reserve Banks to control speculative operations by member banks. More definite separation of deposit and investment banking was demanded; branch banking within States was facilitated and the regulations governing demand and time deposits were tightened considerably. The payment of interest upon demand deposits was prohibited.

Reference may also be made here to the Federal Securities Acts signed on May 27th, laying down more stringent regulations to control the issue of new securities, and the Decree of April 5th prohibiting gold hoarding and requiring the return of hoarded gold to the banks before May 1st.

The Agricultural Adjustment Act incorporates the earlier Farm Relief Bill containing proposals for contraction of acreage, and the Farm Mortgage Debt Relief Bill for the refinancing of farm debt. This Bill provides the basis of the agrarian programme. The Act is based on the assumption that the fall of agricultural income is a primary cause of economic depression. Federal Farm Loan Bonds bearing interest at 4½ per cent. can be issued to the extent of 2,000 million dollars. Their proceeds are to be used to give mortgage loans to farmers at 5 per cent. to enable them to repay existing mortgages carrying higher rates of interest.⁶

The Thomas Amendment Act incorporated in the Agricultural Adjustment and Farm Mortgage Act approved on May 12, 1933, makes provision for a variety of inflationary methods to raise prices in general. The dollar can be devalued to any amount to the extent of 50 per cent. The Federal Reserve Banks can conduct, throughout specified periods, open market operations in obligations of the United States Government or corporations in which the United States is the majority stockholder, and purchase direct and hold in portfolio for an agreed period or periods of time Treasury Bills or other obligations of the United States Government in an aggregate sum of 3,000 million dollars on the security of which bank notes of an

⁶ See *National Recovery Measures in the United States*, p. 37, Geneva, 1933.

equivalent amount may be issued. The President is authorized for a period of six months from the passage of this Act, namely, from May 12, 1933, to accept silver in payment of the whole or any part of the principal or interest from any foreign Government on account of any indebtedness to the United States. The price of such silver is not to exceed 50 cents an ounce in the United States currency. The Treasury has the power to issue silver certificates in such denominations as it deems advisable to the total number of dollars for which such silver was accepted in payment of debts. Such silver certificates can be used by the Treasury in payment of any obligations of the United States.⁷

It may be premature to pass judgment on recovery measures in the United States. In this connection the relevant sentences from the *World Economic Survey*, 1932-33, may be quoted to the effect that "it is not yet possible, therefore, to state with any certainty the precise ways in which it is likely to develop the extent to which use will be made of the wide powers entrusted to the President's discretion, or the relative emphasis which will be given to one aspect or another of the developing plan in face of circumstances and attitudes that cannot yet be clearly foreseen. In the same way, it is possible to record the latest statistics of prices, employment, wages, production, trade and other economic phenomena; but it is not possible to estimate the cause of such changes as have taken place. Economic forces work slowly and sometimes take unexpected directions. It is not yet clear how far the improvements and recessions of industry in the first weeks of the new plan's operation are due to that plan or the result of prior causes. Nor can it be expected that the forces liberated by the plan have yet produced their final or even their most important effects." (Page 310.)

⁷ See *National Recovery Measures in the United States*, Geneva, 1933, pp. 47-50. Also *World Economic Survey for 1932-33*, p. 314. Geneva, 1933.

CHAPTER XXII

The London Money Market

THE Lombards and the goldsmiths in England carried on the business of money-lending and coin changing. The London goldsmiths became money changers on a large scale and also made a good deal of profit by selling gold and silver coins which they were constantly purchasing and melting down for the purpose. They began to attract deposits as they needed funds to carry on their business and their methods of obtaining these funds were not very honest.¹ The germs of deposit banking which has been developed to the pre-eminent position of to-day lay in the methods of attracting deposits by the goldsmiths. They were carrying on business the like of which is carried on in modern times. They conducted exchange operations, bought and sold metallic money, advanced money against security, accommodated merchants by purchasing their bills of exchange and opened current accounts, a business which is now done by joint-stock banks. Notes were issued against these deposits and documents resembling modern cheques were issued by some of them. The London merchants began to deposit their money with goldsmiths because Charles I misappropriated a sum of about £ 120,000 which had been deposited by London merchants in the Tower of London for safe custody. The goldsmiths soon began to have much more money than was safe or convenient for them to retain on their own premises and hence they began to entrust that money to the Government Exchequer. In 1672 a sum of £ 1,328,526 was appropriated by Charles II because he urgently needed money for a war which he was waging against the Dutch. The repudiation of the debt by Charles II sounded the death knell of the goldsmiths as bankers and later, some firms of repute of these goldsmiths carried on a separate banking business. There was the need of a central institution which could act as the medium for government finance and take charge of the people's money without fear of repudiation. The goldsmiths had evolved a market in which gold and silver could be dealt in and it remained for a more powerful body to build upon the foundations.

The time was ripe for the founding of the Bank of England and on a promise from William Paterson, a Scot, to lend £ 1,200,200 to the Government, the latter granted a Charter in 1694 and the subscribers were incorporated under the style

¹ See *The London Money Market*, by W. F. Spalding, p. 23, Fourth Edition, 1930.

of "The Governor and Company of the Bank of England". The Bank issued notes on which it paid interest and they were payable to order and their convertibility was not certain and within three years the Bank had to suspend payment of its notes in cash.

The Act of 1694 was amended from time to time, but up to 1844 the amendments were not stringent enough to limit the amount of note issue which was at the discretion of the Bank's Directors. The Bank Charter Act of 1844 introduced this sort of amendment and under the terms of the Act the Banking Department and the Issue Department were to be entirely separate and ever since then the management of the note issue has been a function separate from all other functions of the Bank. The future note issue of the Bank was made largely a matter of routine and on August 31, 1844, the Banking Department was ordered to transfer to the Issue Department securities to the value of £ 14,000,000 and so much of the gold coin and gold and silver bullion as was not required by the Banking Department. These were the assets of the new Department and the Issue Department took over from the Banking Department such an amount of Bank of England notes which together with those in circulation were equal to the total value of the securities transferred. The silver in the Issue Department was not to exceed $\frac{1}{4}$ of the gold deposits. The fiduciary issue was thus limited to £ 14,000,000 and all notes in excess of that amount were to be covered by gold or silver coin or bullion. It was also provided that if any bank which was issuing notes on May 6, 1844, ceased to issue them subsequently the Bank of England was authorized to issue additional notes against securities to an amount not exceeding two-thirds of the amount of the notes withdrawn from circulation by the banker who ceased to issue them.

The Bank Charter Act of 1844 provided that a weekly account known as the Bank of England Return should be rendered in a prescribed form to the Commissioners of Stamps and Taxes. The Issue Department was to show the amount of Bank of England Notes issued by the Department and the amount of gold coin and of gold and silver bullion held by the Department together with the amount of securities held. The Banking Department was to show the capital stock, the deposits and the money and securities belonging to the Bank of England. This statement is issued each Thursday when its copies are freely available to the public.

Form of the Bank of England Return as it appeared before November 21, 1928.

An Account pursuant to the Act 7 and 8 Vict. Cap. 32,
for the week ending on Wednesday, the 21st day of
November 1928.

C. P. MAHON,
Chief Cashier.

ISSUE DEPARTMENT.

| | £ | | £ |
|-----------------|----------------------|---------------------|----------------------|
| Notes Issued .. | 180,964,085 | Government Debt .. | 11,015,100 |
| | | Other Securities .. | 8,734,900 |
| | | Gold Coins and | |
| | | Bullion .. | 161,214,085 |
| | | Silver Bullion .. | ..... |
| | <u>£ 180,964,085</u> | | <u>£ 180,964,085</u> |

Dated the 22nd day of November, 1928.

BANKING DEPARTMENT.

| | £ | | £ |
|--|----------------------|--------------------------|----------------------|
| Proprietor's Capital .. | 14,553,000 | Government Securities .. | 48,340,327 |
| Rest .. | 3,204,147 | Other Securities .. | 34,757,491 |
| Public Deposits (Including Ex-chequer, Savings Banks, Commissioners of National Debt and Dividend Accounts) .. | 14,898,189 | Notes .. | 48,161,710 |
| Other Deposits .. | 99,472,105 | Gold and Silver Coins .. | 870,504 |
| 7 Day and Other Bills .. | 2,591 | | |
| | <u>£ 132,130,032</u> | | <u>£ 132,130,032</u> |

Dated the 22nd day of November, 1928.

C. P. MAHON,
Chief Cashier.

The first item on the debit side of the Issue Department is 'Notes Issued' which represents the notes issued against the cover set out on the credit side of the account. The first item on the credit side is 'Government Debt' which is the sum lent by the Bank to the Government from time to time. This exists simply as book debt and there is no actual Government Stock representative of this amount. The Government pays 2½ per cent. interest on the debt to the Bank. This is permitted to form a part of the securities against which the Government allowed the Bank to issue notes to the extent of £ 14,000,000 in 1844. The item 'Other Securities' denotes securities which the Bank has to keep as a cover for the fiduciary issue limit. The fiduciary issue grew from £ 14,000,000 in 1844 to £ 19,750,000 in 1923 as follows:—

| Issue of Notes authorized— | | £ |
|--|----|--------------------|
| By the Bank Charter Act, 1844 .. | .. | 14,000,000 |
| By Order in Council of Dec. 7, 1855 .. | .. | 475,000 |
| ,, July 10, 1861 .. | .. | 175,000 |
| ,, Feb. 21, 1866 .. | .. | 350,000 |
| ,, April 1, 1881 .. | .. | 750,000 |
| ,, Sept. 15, 1887 .. | .. | 450,000 |
| ,, Feb. 8, 1890 .. | .. | 250,000 |
| ,, Jan. 29, 1894 .. | .. | 350,000 |
| ,, March 3, 1900 .. | .. | 975,000 |
| ,, Aug. 11, 1902 .. | .. | 400,000 |
| ,, Aug. 16, 1903 .. | .. | 275,000 |
| ,, Feb. 13, 1923 .. | .. | 1,300,000 |
| | | <hr/> £ 19,750,000 |

'Gold Coin and Gold Bullion' represents the gold cover for all notes issued by the Bank in excess of the fiduciary portion. In 1844 silver bullion was allowed to be kept as a part of the cover for notes issued in excess of the fiduciary limit, but as silver is not the legal tender in England and the price of the metal is fluctuating, the Bank does not keep any silver bullion in reserve.

In the Banking Department on the debit side, the first item is Proprietor's Capital which represents the paid-up capital stock of shareholders represented by the loans and advances granted by the Bank to the Government from time to time. Since 1844 the amount has been £ 14,553,000. 'Rest' is the next item corresponding to the reserve of any other bank. Its amount is never allowed to fall below £ 3,000,000 and any surplus over it is distributed in the form of dividends between stockholders. This reserve for the first time was started in 1722 to be drawn upon in times of emergencies and it is entirely separate from and should not be confused with the Reserve represented by the total of the notes and gold and silver coin in the Banking Department.

The item 'Public Deposits' represents the funds of the Government held by the Bank and it includes the balances of the Exchequer, Savings Banks, Commissioners of National Debt and other dividend accounts. Its amount increases from Christmas till March because of receipts from income-tax and land tax and also from July to August as income-tax is payable in two instalments.

'Other Deposits' is the next item on the Liabilities side of the Banking Department which represents the total balances held at the Bank by its private customers and corresponds to the current account balances of the other joint-stock banks

together with the balances of many of the other banks in the country which keep accounts with the Bank of England. It also includes balances of various government bodies as the India Council, etc. Most of the banks outside the 'clearing' including the London Offices of the colonial banks maintain balances with the Bank of England as a matter of convenience. The balances of nearly all the banks of the country are included in this item.

The amount of the 'Seven Day and Other Bills' is now unimportant. They are usually in amounts varying from £ 10 to 1,000 and the Bank of England is the only London Bank issuing these bills now.

On the assets side of the Banking Department the first item is 'Government Securities' which includes investment securities of the British Government, Ways and Means Advances to the Government and Deficiency Advances. In anticipation of revenue the Bank allows overdrafts to the Government which are included in the item.

'Other Securities' is the next item which includes the investment securities held by the Bank on its own account. It makes advances to bill brokers and ordinary customers on the strength of various securities which are included under this head.

'Notes' and 'Gold and Silver Coin' represent the Reserve the ratio of which to the deposits is important. This Reserve is not only the basis of the Bank's credit, but is also the key to the Bank Rate.

The form of the Return of the Bank of England as fixed under the Currency and Bank Notes Act of 1928 was as follows :

*An Account for the week ended on Wednesday, the 28th
day of November, 1928.*

ISSUE DEPARTMENT.

| | £ | | £ |
|-----------------------------------|-------------|-----------------------------------|--------------|
| Notes Issued— | | Government Debt | 11,015,000- |
| In Circulation .. | 367,001,148 | Other Government Securities .. | 223,568,550- |
| In Banking Department .. | 52,087,797 | Silver Coin .. | 5,240,157 |
| | | | |
| Amount of Fidu- ciary Issue .. | | 260,000,000- | |
| Gold Coin and Bullion .. | | 159,088,945 | |
| | | | |
| £ 419,088,945 | | £ 419,088,945 | |

Dated the 29th Day of November, 1928.

C. P. MAHON,
Chief Cashier.

BANKING DEPARTMENT.

| | £ | | £ |
|----------------------|---------------------|----------------------|---------------------|
| Proprietor's Capital | 14,553,000 | Government Secu- | |
| Rest | 3,254,001 | rities | 52,180,327 |
| Public Deposits | | Other Securities— | |
| (Including Ex- | | Discounts and | |
| chequer, Savings | | Advances | |
| Banks, Commis- | | £13,568,293 | |
| sioners of National | | Securities | |
| Debt and Dividend | | £20,214,855 | |
| Accounts) | 21,452,051 | | 33,801,148 |
| Other Deposits— | | Notes | 52,887,797 |
| Bankers £62,379,409 | | Gold and Silver Coin | 757,041 |
| Other Accounts | | | |
| | £37,185,203 | | |
| | <u>99,564,612</u> | | |
| 7 Day and Other | | | |
| Bills | 2,649 | | |
| | <u>£138,826,313</u> | | <u>£138,826,313</u> |

Dated the 29th Day of November, 1928.

C. P. MAHON,
Chief Cashier.

Certain innovations have been made according to the latter Return. In the Banking Department, 'Other Deposits' are not divided into 'Bankers' Deposits' and 'Other Accounts'. The former item includes the cash balances of all the London clearing banks, English joint-stock and private banks and the Scottish and Northern Irish Banks, and the latter item includes the deposits of private customers, such as the large industrial firms which keep accounts with the Bank of England.

The item 'Other Accounts' includes the ordinary banking operations and transactions arising from its international relationships.

On the other side of the account 'Other Securities' are now sub-divided into 'Discounts and Advances' and 'Securities'. The difference between the two is not clear. One opinion is that when a bill is discounted on the initiative of the market, it will be ranked as a 'discount'; but when the bank buys bills on its own initiative as part of its open market policy, it will be called a 'security'—'Government Security' for Treasury Bills and 'Other Securities' for commercial bills. Another opinion is that a bill discounted, whether a treasury or other bill, will come under 'Discounts and Advances'.

CONSTITUTION OF THE LONDON MONEY MARKET

The funds employed in the London Money Market come from the Bank of England; the 'Big Five' as they are called

—viz., the Midland Bank, Ltd., Lloyds Bank, Ltd., The Westminster Bank, Ltd., Barclays Bank, Ltd., and the National Provincial Bank, Ltd.; other British banks including four in the London Clearing, namely, Martin's Bank, Ltd., Williams Deacons Bank, Glyn Mills & Co., and Coutes & Co.; the Discount Houses including the Union Discount Company, the National Discount Company, and Alexanders; bill brokers, stock brokers and other finance houses. The idea of the funds available in the market may be had from the following table of figures:—

| | £ |
|--|-------------------------|
| Bank of England Deposits | 121,016,663 |
| The Deposits and Cash of the "Big Five" | 2,032,752,000 |
| Total Deposits of all British Banks | 2,240,513,214 |
| Discount Houses | 94,957,000 ² |

The joint-stock banks and the discount houses constitute the liquid portion of the London Money Market. The loans of the discount houses on the market represent cash previously borrowed from the banks and, therefore, too much attention need not be devoted to their balances. These banks get the huge supplies of money from their customers and they lend a part of it to the bill brokers, stock brokers, etc., utilize a certain portion in the form of advances to clients, make investments in gilt-edged securities and bills of exchange and keep a certain portion in the reserve to meet the demand liabilities.

When interest on War Loans is paid to bond holders, they deposit the interest warrants with the joint-stock banks and if the latter find that they cannot use all the funds, they deposit a portion with the Bank of England. The result is that the amount of the 'Public Deposits' in the Bank of England falls and that of the 'Other Deposits' rises on account of a transfer entry in the books of the Bank of England. If the demand for accommodation from the open market or from the customers of the banks cannot absorb the funds available at the banks, they can 'increase their investments by the difference between the cash received and the proportion they require to hold against an increase in their deposit liabilities.' This method has largely been followed during and after the war by the banks. Their surplus cash has been used by them to purchase Treasury Bills and other short-term Government securities.

HOW LOANS CREATE CREDITS

A person borrows money from a bank and may not withdraw actual cash. The amount will be placed to his credit and he will draw cheques on this amount in favour of people

² See *Ibid.*, Chapter V, pp. 67-69.

who have sold goods to him. For the sake of simplicity, it may be assumed that these sellers also have accounts with the same bank. They will then pay in these cheques to the credit of their own accounts in the bank. When the borrower has withdrawn the whole sum standing to his credit, there would still be the same amount of credit outstanding, though the amount would be distributed among the accounts of various people. It is in this way that the loan creates credit of an equal amount.

There remains the question of repayment which may be made by the credits created by the loan itself or through credits created by some other loans. In the latter case, the person repaying may have received cheques from other persons who in turn had raised loans with their respective banks. This process of loan making and creation of credits could go on indefinitely; but as credits are diffused among different people, they pay them into their accounts with their banks and the banks are under an obligation to repay them on demand or at some short notice.

Loans are in different forms—at call and short notice to discount houses, bankers' advances to commerce and industry, bills of exchange discounted and investments in Treasury Bills, bonds, etc. Some of the credits created like the call loans are repayable on demand, some at short notice and others at distant periods. The ultimate result is, however, similar.

We may now follow the operations of the Bank of England in this respect. Loans are granted to various Governments and firms. In the Bank Return, the securities for loans made to Governments come under "Government Securities" and those for loans advanced to firms come under "Other Securities". The amounts placed to the credit of the Governments are known as "Public Deposits" and those placed to the credit of firms are known as "Other Deposits". When the loans are paid off, the securities are released, and there is a decrease in securities held and deposits also. This will not be the case if cash is taken out by the loan and paid in by a deposit.

DEMAND AND SUPPLY OF FUNDS IN THE LONDON MONEY MARKET

The "Bankers' Deposits" at the Bank of England represent the balances of London bankers. Banks receive money for safe custody from their clients and keep their own surplus money with the Bank of England. These bankers' balances represent a very large portion of the money stock of the London Money Market. Anything which affects the market is also bound to affect "Bankers' Deposits" and "Other Accounts". If bankers' surpluses cannot be utilized, the amount of these

items will rise, but if there is a keen demand for their spare cash, they will fall.

"Other Deposits" (Bankers' and Other Accounts) provide the key to the position of the London Money Market at any time. Money rates rise and fall with the movements in "Other Deposits". These are the actual balances of banks and other concerns that keep accounts with the Bank of England. "Other Deposits" will thus rise by a superfluity of supply and will fall by a scarcity of funds. The figures of the bankers are an evidence of a reserve in cash against liabilities and bear a close relationship to liabilities. High "Other Deposits" show a weak position unless the reserve of notes is proportionally high. The amount of "Other Deposits" shows approximately the strength of the market which can be tested by the Bank Rate and the Market Rate.

The Bank Rate is the minimum rate at which the Bank of England is prepared to discount approved bills of exchange of not more than 15 days' currency. It is also the rate at which the Bank makes advances on marketable short securities whose currency does not usually exceed a week. In reality the Bank makes an extra charge of $\frac{1}{2}$ per cent. over Bank Rate for loans to the market. Market Rate is the rate of interest at which the joint-stock banks, the discount houses, the brokers, etc., are willing to discount bills of exchange and to lend money. The Market Rate is lower than the Bank Rate because the great joint-stock banks have immense funds and can do business at lower rates than the Bank of England. The Market Rate depends upon the rate of interest which the banks allow on short deposits of their customers. This deposit rate is governed by the Bank of England Rate and, therefore, the joint-stock banks cannot break very far away from the Bank of England. In abnormal times, however, there may be a considerable divergence between the Bank Rate and the Deposit Rate.

The Bank of England can exercise a great influence over the value of money in the market because the stock of money in its control is a very important part of the general supply. The depositors of the joint-stock banks regard the Bank of England Rate as the basis for the interest they expect on their deposits with joint-stock banks. They expect to receive something near the Bank Rate. People know that the rate of short deposits allowed by the joint-stock banks rises or falls with the Bank Rate. But, of course, too much reliance should not be placed upon this factor as a criterion of the rates allowed by the banks themselves. The banks do not pay interest on money on current account. "Consequently, the rate at which the bankers lend, or at which they discount bills will depend

upon the average rate the money costs them ; when the interest they pay on deposits is spread over the whole of their balances, although some money is on long deposit at higher rates yet the price they pay for the total sum will be comparatively small, and they will, therefore, be able to lend at considerably lower rates than if they had to give interest on all the money deposited with them." Since the rise of the joint-stock banks and the enormous progress they have made in the London Money Market, the influence of the Bank of England is not as great as formerly and in normal times the market can absorb most of the bills offered. Since 1878 the Bank of England has been purchasing bills from its customers at the rates prevailing on the open market. In periods of change and adjustments more bills are offered in the market than can be discounted and the Bank of England is approached for accommodation and it has still the last say in the matter.

In times of crisis the control of the Bank over the market is plain and it is readily discernible at a time of scarcity of ready money. It is in this way. The money in "Other Deposits" belongs to banks and all of it is not at the disposal of the market. Only a portion of this money is utilized for the benefit of the open market. The deposit at the Bank of England is regarded as gold by the depositor. Banks usually keep a certain proportion of their funds in a liquid form and up to this extent they will meet the requirements of the market by discounting bills of exchange and by lending money. If there is a pressure for money, the banks will call in their money which has been lent at call or short notice and if the pressure continues, they will either not discount bills or will not discount them for cash. The holders of the bills of exchange in such circumstances will approach the Bank of England for assistance. The Bank will then meet the requirements of the bill brokers and the discount houses by discounting approved bills of exchange which have to run only a short period or lend money on gilt-edged securities which have to run for a short time. Under such circumstances the Bank can dictate its own terms and exact its own rates. The price charged for accommodation is always higher than that which could be obtainable previously on the open market. The Bank insists that the loans should be taken for a full week at $\frac{1}{2}$ per cent. over the Bank Rate.

The utility of the Bank rate in checking the outflow of gold is great. A rise in it lessens the demand for loans, checks expenditure in the country and lowers prices which decreases imports and encourages exports. The aim is contraction of currency. This helps to restore the adverse trade balance which is the primary cause of the foreign demand for gold.

A rise in the rate attracts gold from foreign countries and a fall means easy money market. The success of this policy depends upon the support the Bank of England receives from the other possessors of funds in the London Money Market. This support can be easily obtained if there is a comparative shortage of funds, but if the supply of money is high as will be evidenced by a high level of "Other Deposits," the Bank of England will not be able to influence the rates in an upward direction in the early stages because the competition of outside lenders will bring the rates down.

In the pre-war days the Bank of England could force up money rates by raising its own rate again and again till it became effective. The Bank followed the line of least resistance and relieved the market of surplus funds by acting as the borrower. It sold consols for cash and bought them again for account. The purchasers paid by cheques on member banks which reduced the balances at the Bank of England. With a fall in "Other Deposits" the borrowers would go unsatisfied unless they were prepared to pay higher rates. During and after the war, this method has been unnecessary. The monthly settlement was stopped after the war on the Stock Exchange and was not reintroduced till 1922. The existence of a large amount of Treasury Bills has entirely changed the control of the market. The Treasury Bills absorb a large amount of funds and the money received in exchange for these bills could be easily kept off the market for a time. This expedient has not been resorted to in practice, but it shows the power of the Bank over the market. The money so received quickly returns to the market because the Government has to pay money to contractors and others. These receipts in some cases go to repay the Bank of England loans on Ways and Means advances. This money is under the control of the Bank and can be released to the market or withheld at the discretion of the authorities. If the Bank wants to send up the open market rates, it sells Treasury Bills for spot cash and reduces the supply of money in the market which makes the Bank Rate effective. When the outside market is thus compelled to approach the Bank for accommodation, the Bank is in control of the market and can charge high rates and bring the other dealers in money up to the desired level.

SHORT LOAN FUND OF THE LONDON MONEY MARKET

Short loan fund means the total of short loans running at any particular time. This fund is not a reservoir having definite limits, but is a fluctuating item in the money market and the amount that the lenders can place at the disposal of the borrowers cannot be known with precision. The funds of the discount houses employed in discounting bills need not

be included in the short loan fund because they purchase and sell bills of exchange under discount and though at times they may have more funds at their disposal than they can employ in bill business, they cannot be regarded constant lenders like the clearing banks. The foreign and colonial banks with London Offices contribute something towards this fund though their exact amount cannot be known. They lend money to the open market, but only during such times as they have money waiting to be employed in the finance of exports from England. The average monthly amount of the short loan fund employed by the ten clearing banks for 1929 came to £ 145,364,000.³

Apparently the short loan fund is inelastic. Loans can be made to the market up to a certain point at which the banks cease to be lenders and begin to call in money from the market. One banker may be obliged to call money from the market which finds its way into the till of another bank. This operation appears to be simply an act of exchange and no new addition to the fund is made. If new gold arrives into the country, the fund is increased by an equivalent amount which is released to the market. Thus in reality the fund is not a reservoir with definite limits. The short loan fund is not solely in the hands of the clearing banks and the Bank of England also supplies funds which are available for the market. It is not merely by a process of discounting bills that the fund can be replenished. At times the outside market will not discount a single bill. In case of need the banks may have withdrawn all their funds from the short loan fund. It is at this point that the Bank of England intervenes and discounts approved

³ The Money Employed by the ten Clearing Banks on the Short Loan Fund of the London Money Market, being the Total of their "Money at Call and Short Notice".

| | | | £ |
|------------|---------|-------|-----------------------|
| January, | 1929 .. | .. .. | 149,829,000 |
| February, | 1929 .. | .. .. | 138,214,000 |
| March, | 1929 .. | .. .. | 136,133,000 |
| April, | 1929 .. | .. .. | 145,156,000 |
| May, | 1929 .. | .. .. | 145,505,000 |
| June, | 1929 .. | .. .. | 152,464,000 |
| July. | 1929 .. | .. .. | 144,468,000 |
| August, | 1929 .. | .. .. | 145,119,000 |
| September, | 1929 .. | .. .. | 150,284,000 |
| October, | 1929 .. | .. .. | 149,774,000 |
| November, | 1929 .. | .. .. | 144,271,000 |
| December, | 1929 .. | .. .. | 143,153,000 |
| | | | <u>£1,744,370,000</u> |

Average monthly amount £145,364,000

(London Money Market, by W. F. Spalding, p. 110.)

bills of exchange. The Bank grants loans in such cases for somewhat longer periods than those for which loans are made by the outside banks from the short loan fund. It cannot be said, therefore, that the accommodation granted by the Bank of England comes from the short loan fund. At times the Bank of England lends money to its own customers at the same terms as the open market which increases the short loan fund because the Bank of England need not withdraw from the short loan fund an equivalent amount as the other banks have to do. Thus the short loan fund readily adjusts itself to demands made upon it, though temporarily recourse to the Bank of England is necessary.

MAIN POINTS IN CONNECTION WITH THE FUND

1. The London Money Market is so elastic that it will, at a rate, always respond to the demand made upon it.
2. The deposits of the banks are made as either cash deposits or credit deposits. The bankers themselves create all their credit deposits.
3. They create these credit deposits in the proportion that they maintain between their cash and their liabilities. The credit deposits increase or decrease according as the proportion decreases or increases.
4. The Banks themselves decide what the proportion shall be.
5. It is the practice of the banks to extend the creation of credit so that they only retain the minimum proportion of cash which they consider necessary for their own safety.
6. As soon as the safety limit is passed, the banks have to call in loans to regain their necessary minimum proportion of cash and the market has to borrow at the Bank of England.
7. As soon as such borrowing begins at the Bank of England, the latter obtains control of the market.
8. As the banks usually work up to the safety limit, a very slight displacement of money will, as a rule, necessitate borrowing at the Bank of England.
9. If the bankers decide to increase the aggregate of their balances at the Bank of England, they can do so only with the co-operation of the Bank of England itself.
10. The nature of the credit created by the Bank of England is the same as that created by other banks.
11. Unless loans made by the Bank of England are withdrawn in cash, the loans do not affect the reserve of the Bank of England, but only its "proportion", that is, the ratio of its reserve to its liabilities on deposits. This is the same in

effect as loans made by other banks, and the Bank of England decides whether its "proportion" at any time is sufficient.

12. If the Bank of England decides that it is desirable to check gold exports from this country, or that more gold must be attracted from abroad as the basis of credit in this market, it will raise its minimum rate of discount; in the reverse case it will lower its rate in the interests of the trade of the country.

THE OPEN AND DISCOUNT MARKET

The short loan operations and the discount or open market operations are intimately connected and the discount market is a very important section of the London Money Market. Discounting a bill means that the holder of the bill of exchange wants funds and can sell it to a purchaser for less than its face value. He is put in possession of funds immediately and, therefore, he can part with the bill for less than its face value which will be due after some time.

The London joint-stock banks do not deal directly with the purchasers and sellers of bills of exchange, but through intermediaries known as the bill brokers. A bank manager cannot possibly come into direct touch with purchasers and sellers of bills specially when the banking business has centered in the hands of a few big banking corporations. Therefore, most of the discounting business is conducted by specialists known as bill brokers and discount houses.

There are the original possessors of the bills for discount, the London offices of the colonial and foreign branch banks. They receive bills of exchange for collection and at times are in need of money immediately. In such circumstances they get the bills discounted and utilize the proceeds in financing exports. There are the London offices of the joint-stock banks.

The manager of each bank has a finance book having a record of the amounts to be received on one side and a record of the amounts to be paid on another side. The excess of receipts over payments shows the balance which the bank manager can utilize in lending money on the security of bills of exchange. An estimate is made of the payments to be made during the day and of possible receipts also. The manager of a London joint-stock bank is in a better position in this respect than the manager of a colonial bank. The latter has often unforeseen demands as he may get a cable asking him to be ready to meet the drawings that are being made upon him during the day; but the manager of a joint-stock bank knows his requirements approximately for the week.

The loans are usually granted for seven days. If the

market is well supplied with funds, the banker will like to increase his loans to the broker, but if funds are scanty he will not lend more than the sum for which usually an arrangement is made. The foreign and colonial banks lend money from day to day owing to the special nature of their business. They cannot know their requirements in advance and cannot therefore place funds at the disposal of the brokers for a week or so. They prefer to lend for a day or for a period of 24 hours. The amounts range for £ 50,000 and upwards. The banks have the right to recall this money next morning. Hence it is known as 'night' or 'bad' money. Such loans are not liked by brokers, but they can tide over a period up to 24 hours. This money is lent at lower rates than the weekly fixtures, i.e., the rate charged for overnight money is lower than one charged for loans for a week. Arrangements are made by the brokers on phone or through personal visits and they find out which bankers are lenders and which are calling in their loans. When money is unlendable at any price, it is called "a drug on the market".

There may be a time when the banker may have no balance or may have a balance on the liabilities side for the day. Then he will call in his day-to-day loans and will not renew his weekly loans. There may be a time when all the bankers are calling in their loans, because of scarcity of money due to a great demand for it. The broker then has no alternative except to go to the Bank of England for help. The market in such circumstances is "in the Bank". The broker tries to avoid this position because of the exacting terms charged by the Bank of England. Under such circumstances, the position indicates that the banks have created credit to the utmost limit consistent with safety for the time being.

The securities on which money is lent to the brokers are known as floaters and terminals. The former change hands and float about the market as the short-term gilt-edged bearer securities like the Treasury Bills, Exchequer Bonds and Consols. Terminals are the securities with only a short period to run before they fall due for payment as Treasury Bonds and similar short-dated bonds.

When a banker lends money he gives a cheque to the broker drawn on the Bank of England. Or the broker draws a cheque on the lending banker and gives securities or bills in exchange to the banker. When a loan is called in, the broker gives his cheque on his own banker to the lending banker and gets back the securities. Borrowing and lending operations are always going on and when the broker gets the securities back, he immediately pledges them with another banker to get accommodation.

HOW THESE BILLS ORIGINATE

The bills circulating on the London discount market enter England from foreign countries. In every foreign centre people are ready to export their goods and to facilitate their operations the assistance of the bankers abroad is required. The London branches of the foreign banks purchase bills of English exporters which the latter have drawn on foreign importers. The banks send these bills to their foreign branches and the latter get money in due course. These funds are utilized for purchasing bills offered for sale in foreign centres which are drawn on London. The exporters get payment for their goods by drawing bills on London and the English exporters get payment by selling their bills to London bankers. All such bills find their way into the London discount market.

Bills are also drawn for services rendered and debts due and people will purchase them for sending to their creditors in settlement of their debts and obligations. These are clean bills without documents in any shape or form. They are sent to London to be disposed of in the market.

There are other bills drawn on and accepted by the London accepting houses and the London branches of foreign banks in connection with various financial and commercial transactions. Besides, there are bills in connection with internal trade of the country.

Bank paper means those bills which are drawn on and accepted by the joint-stock banks and finance houses and also those which are drawn on and accepted by the London Offices of foreign banks. In short, bank paper means either bank acceptances or paper endorsed by the banks.

Fine trade paper means all commercial bills drawn and accepted by first class merchants and traders. The term 'clean bills' as far as the Bank of England is concerned means those bills which bear on their face evidence of their being drawn against specific shipment of commodities or other security.

The discount market does not deal with documentary bills, *i.e.*, bills of exchange with shipping documents attached. Bills originally drawn with shipping documents attached become "clean" after the documents have been delivered on the acceptance of the bills.

CHAPTER XXIII

Bank for International Settlements

THE scheme for the Bank for International Settlements was formulated in March 1929 by the Committee of Experts in Paris. This proposal of the Young Committee was the logical outcome of the evolution of post-war financial history, which was characterized by two currents: the attempt to restore monetary stability through the co-operation of central banks, and the endeavour to adjust to realities, reparations and war debts claims. Both these factors were moving towards the establishment of an international organization of some kind. Though they were advancing independently of each other, they reached the stage in a simultaneous way when the need for the creation of an international body of some kind had made itself felt more acutely, and when its realization had become a matter of practical politics.

Monetary conditions in the immediate post-war period exhibited a picture of desperate chaos. The year 1923 was the culminating period of the post-war crisis in European finance. Budgetary deficits, currency inflation, depreciation of exchanges, increasing expenditure and rising prices were the common economic phenomena. The former continental belligerents found it impossible to raise an external loan and the few experiments in this connection resulted in a failure, thus discouraging further attempts.

The first sign of relief was the stabilization of the Austrian exchange. A reconstruction scheme was put into operation, the credit for which was due to the Financial Committee of the League of Nations and to the Governments which relinquished the priority of their claims and guaranteed a portion of the Reconstruction Loan. Thus Austria could get the necessary funds for the stabilization of the Krone. The Bank of England played an important part in this connection by granting an advance to the Austrian National Bank so that Austrian exchange could be stabilized during the transitional period between the conclusion of the agreements for the reconstruction scheme and the actual issue of the loan. The reconstruction scheme could not have succeeded without this advance.

This was the first public act of co-operation between central banks in the post-war period. In the beginning this movement of co-operation was one-sided because the stronger

banks supported the weaker ones. Later on, it gradually developed into a system of reciprocal support. In theory, the co-operation was to be only between central banks on a gold basis, but on several occasions, central banks of countries with inconvertible paper currencies were also admitted.

There were two main objects of the movement: (1) the attainment of economic reconstruction and monetary stabilization, and (2) the prevention for a scramble for gold by central banks. There was a subsidiary object also, namely, the establishment of closer business relations between central banks. At the same time, the solution of the problem of reparations transfers also was facilitated.

The Bank of England also rendered similar services to the Hungarian National Bank, and it returned the interest paid on its advances to these institutions. In the case of Germany a group of central banks supported the Reichsbank by placing capital at the disposal of the Gold Discount Bank. The number of participants in the movement continued to increase and the stabilization of the Belgian franc, the lira, the zloty, the drachma, etc., was carried out with the help of the credits granted by the growing group of central banks. When the gold standard was restored in Great Britain the support was granted exclusively by the Federal Reserve System.

The efforts of central banks in this respect were generally conducted within the framework of the schemes of the League of Nations; but on certain occasions they acted independently. In the case of Poland, a scheme was worked out without the assistance of the League of Nations.

It is true that the co-operation of central banks in the stabilization of currencies was commendable; but there were certain disadvantages also of this course. The central banks which extended their support were too dictatorial towards the countries which needed their support and, therefore, this sort of help was considered as a sign of inferiority by the weaker banks. Thus countries which could do without the support of the group of central banks obtained help from other quarters. The Danish National Bank, for instance, stabilized its exchange with the help of credits granted by Hambros Bank and American banking interests. Similar was the case with the Bank of Spain.

In the case of Bulgaria and Estonia the supporters insisted that the central banks should be controlled by private shareholders and not by Government. This caused inconvenience to the central banks standing in need of support. Ultimately, of course, these dictatorial methods were beneficial, but the countries standing in need of support became less and less

inclined to submit to them. They reluctantly consented in case of emergency, but as conditions became normal, they were less willing to accept interference from outside.

It was, therefore, desirable to devise arrangements by which the countries standing in need of support could participate in the authority which determined the terms of the support. To ask for and get assistance in this manner would be less humiliating. This was one of the *raisons d'être* of the Bank for International Settlements.

The second principal aim of the movement of co-operation was to prevent a scramble for gold. It will be seen that the assistance given by central banks for currency stabilization was not merely an act of philanthropy. It was to the interest of the supporters also to create free gold markets. Most central banks are authorized to include foreign exchanges into their gold reserves, but there was a tendency on their part to replace these currencies with actual gold. This might mean a sudden demand for gold sometimes and might lead to heavy withdrawals of gold which would prove embarrassing. Therefore an understanding was reached by which central banks undertook not to withdraw gold from each other without each other's consent.

This principle had also been extended to the South African gold dealt with in the open market in London. It was the Bank of England which carried out the buying orders on behalf of other central banks. It was to the interest of the central banks themselves to co-ordinate their demand for South African gold to avoid competition which would force them to pay a higher price. This understanding did not work well and the Bank of France and the Reichsbank made heavy withdrawals. The co-operation between central banks had not thus reached an ideal state and the Bank for International Settlements could play a useful part in this direction.

An auxiliary means by which central banks have been co-operating is the establishment of closer business relations with each other. This tendency has been stronger in the post-war period than in the pre-war period. For instance, the Reichsbank and the Bank of France established accounts with each other for the first time in their history in the post-war period, and the Reichsbank introduced a system facilitating the transfer of funds from one country to another through central banks.

Another auxiliary function of co-operation between central banks was to facilitate the task of the Agent-General for Reparations Payments of the transfer of funds.

This movement of co-operation was gradually working towards the restoration of normal conditions ; but its shortcomings

were becoming evident. It was too informal and too vague in character and its agreements had no binding force. Its working also was too clumsy and casual. There was, therefore, a great necessity for an organization to systematise the co-operation of central banks. Such an organization appeared to present the following advantages:—

(1) It could place co-operation on a systematic basis and the casual character of the movement could be replaced by a systematic organization.

(2) A central administrative organization could be provided, because before the establishment of the Bank for International Settlements there was no body engaged in organizing and co-ordinating the movement.

(3) Personal intercourse between central bankers could be facilitated, because the new organization could provide an opportunity for frequent meetings of the leading central bankers.

(4) It could also establish discipline among central banks, because the existence of the organization was expected to reduce the number of violations of the principles. It is less humiliating to accept the ruling of the Bank than to submit to the decision of individual central banks.

(5) The movement of co-operation was expected to be more efficient, because it was expected to avoid much waste of time in the arrangement of credits, etc.

(6) It was expected to increase the number of countries on a gold basis, because the central banks which were not on gold standard were excluded from participating in the share capital of the Bank.

(7) It was expected to facilitate the exchange of statistical and other information.

(8) The Bank was also expected to prevent the scramble for gold and to prevent the falling tendency of the international price level.

PROBLEM OF REPARATIONS

The obligation imposed upon Germany according to the Treaty to make huge reparations payments introduced complications into the international money and exchange markets. Inter-Allied debts also worked in the same direction. The principal exchange affected by these factors was the Reichsmark, though their effects upon the currencies of other countries also were not negligible.

The Peace Treaty did not make any provision for dealing with these exceptional factors which were allowed to take their

own course. The Dawes Scheme of 1924 realized the gravity of the situation and it made provision for machinery to regulate the transfers of reparations payments so as to inflict upon the mark the least possible harm. The duty of the Agent-General was to collect reparations and to see the most opportune moments for their transfer to the Allied creditors; while the object of the Transfers Committee was to stop transfers when they endangered the stability of the Reichsmark. The German Government was thus relieved of the responsibility for transfers, and in respect of reparations its duty was to make payments in Reichsmarks only. It was the Agent-General who in co-operation with the leading central banks, arranged the transfers in a way that they might cause the least possible inconvenience in the foreign exchange markets.

The Dawes Scheme could not be put to a real test until early in 1929 when Germany could not raise credits abroad; and after 1929 Germany could not make reparations payments. "Thus it appeared that the fact whether or not the transfers of reparations payments disturbed the exchange depended not so much on the efficiency of the organization of transfers as on fluctuations in the international loan market. But for the replacement of the Dawes Plan by the Young Plan, the clause of the former providing for the suspension of transfers might have had to be applied in order to avoid another collapse of the Reichsmark."¹

There was thus a very great necessity for some central organization which could direct the co-operation between central banks to facilitate reparations transfers. It would not have been easy in the absence of such an organization to secure the support of all central banks to help Germany during the period of transfer difficulties. The fact that reparations transfers would cause fluctuations in the international loan market was unavoidable irrespective of the establishment of any organization so long as the payments exceeded considerably Germany's capacity to pay or her normal resources. But the influence of the caprices of the capital market could be moderated by a permanent central organization equipped with the necessary powers. The same organization could act as trustees for reparations payments and help in the commercialization of reparations payments and also in the financing of deliveries in kind.

A change in the system of reparations payments was also necessitated by the greater prestige and might which Germany had come to occupy in international politics. In 1926 she was admitted to the League of Nations and given a seat on the

¹ *Bank for International Settlements* by Dr. Paul Einzig, page 28, Third Edition, 1932.

Council among the other leading powers. Thus her voice carried considerable weight in international conferences. A change was, therefore, necessary in the humiliating system of control which had been established by the Dawes Plan.

The establishment of an international institution, which could manage reparations payments and which, at the same time, could secure the co-operation of central banks, was highly necessary. The new organization would thus achieve the double object of providing for co-operation between central banks and facilitating the transfer of reparations payments and inter-Allied debts.

It has been pointed out that the combination of the functions of a central office for central banks with those of an office for reparations payments implies some contradiction. Co-operation between central banks is a product of idealism ; but the endeavour to get reparations is a survival of the spirit of hostility and thus the two objects are incompatible. It may be said that reparations would not go on for ever, but the existence of the Bank would be permanent.

From the point of view of the reparations the advantages of the Bank as embodied in the Young Plan are as follows :—

(1) It simplified the whole reparations problem by unifying the existing clumsy, complicated and cumbersome organizations. It introduced economy and efficiency and the Bank is more suitable than any other organization to act as trustee for the reparations payments.

(2) It could be of great help in the commercialization and mobilization of the reparations debt. The principles on which commercialization may take place can be laid down once and the permanent organization would then carry out the mobilization at the most suitable time.

(3) It could play an important part in the direction, control, and financing of deliveries in kind.

(4) It was to provide an authority which could advise the creditor Governments as to the German Government's declaration of its inability to continue the transfer of post-ponable annuities.

(5) It was expected to help Germany to avoid the necessity of suspending transfers ; because under the Young Plan assistance in the form of credits was to be provided for in case of temporary difficulties.

(6) It was to take charge of the investment within Germany of Reichsmark payments made by the German Government during the period of suspension of transfers.

(7) It was expected to create additional facilities for German exports by facilitating the reconstruction of certain countries and the economic development of others.

(8) It was meant to reduce the political character of the reparations problem and it increased neutral elements in the administration of reparations.

(9) It was to contribute, out of its profits, towards the payment of the last 22 annuities to provide relief to Germany.

(10) It was expected to improve financial relations between former belligerents by the establishment of a permanent link between their financial authorities.

(11) It was also expected to prevent a fall in the international price level and thus it was thought by some of the authors of the scheme that it would prevent an increase in the burden of reparations and inter-Allied debts.

FUNCTIONS OF THE BANK

The Young Plan discriminates between the essential or obligatory functions of the Bank and its auxiliary or permissible functions. The former are those functions "which are inherent in the receipt, management and distribution of the annuities"; while the latter are those "which evolve more indirectly from the character of the annuities. There is no hard-and-fast line between the two sets of functions, because the first lead naturally into second."²² The Paris Experts expected a gradual increase in the relative importance of the auxiliary functions of the Bank, and hoped that a time might come when these functions would overshadow the reparations functions for which the Bank was primarily created.

NON-REPARATIONS FUNCTIONS

"(1) Assistance to countries wishing to restore the gold standard.

(2) Assistance in the maintenance of a gold standard in case of emergency.

(3) Assistance in the relief of temporary pressure.

(4) Establishment of an international gold clearing system.

(5) Establishment of an international exchange clearing system.

(6) Regular collection and exchange of information upon the international monetary situation."

The other tasks besides those mentioned above are given below:—

²² Part 5 of the Young Report.

- " (1) To regulate and influence the world price level.
- (2) To assist in the international distribution of credit.
- (3) To take an interest in the financial reconstruction of Russia and China.
- (4) To assume the rôle of trustee for all debt services under international control—for instance, in the case of the Greek external debt.
- (5) To appoint financial advisors to Governments and central banks.
- (6) To assume the control of the arrangements to prevent the counterfeiting of bank-notes.
- (7) To collect and distribute information as to the practice of various central banks in the matter of gold shipments."

The Young Report alludes to the Bank's task of opening up new fields for commerce which leaves a wide scope for imagination. Just possible, it may merely refer to the anticipated increase of international commercial activity as a result of the stabilization of currencies. According to its statutes the Bank is not allowed to acquire shares of or to take a controlling interest in business undertakings. Therefore there could be no question of any direct participation in enterprises aiming at the creation of new markets for export trade. Moreover, the opening up of new countries requires long-term investments, and the Bank is thus hardly suitable for the purpose; but it may assist any scheme by supplying the short-term capital required, if the long-term capital has once been provided for.

The object of the non-reparation functions was to bring about a more equal distribution of the financial resources of the world as between various countries. Through improving the spirit of co-operation between central banks, the Bank was intended to be instrumental in regulating the demand for gold; and by expanding or contracting credit, it was expected to influence world prices.

CONSTITUTION OF THE BANK

The Young Plan made provision for the establishment of the Organization Committee, on which the seven original countries are represented on a basis of equality. The task of this Committee was described as the drawing up and elaboration of the statutes and charter of the Bank, and the making of all preliminary arrangements until the formation of the Board of Directors.

The Board of Directors according to the Young Plan was to be made up in the following manner:—

- (1) The Governor of the central banks of each of the seven original countries was to be an *ex-officio* director of the

Bank. Each of these Governors was to appoint one Director, being a national of his country and representative either of finance or of industry or commerce.

(2) During the period of the German annuities the Governor of the Bank of France and the President of the Reichsbank may each appoint an additional Director of his own nationality, being a representative of industry or commerce.

(3) The Governor of the central bank of each of the other countries participating in the share capital of the Bank should furnish a list of four candidates of his nationality for directorships. Two of them should be representative of finance and the other two of industry or commerce. From these lists the fourteen or sixteen Directors mentioned in (1) and (2) above should elect not more than nine other Directors.

(4) "From those first appointed, four groups of five directors shall be chosen by lot; their terms respectively shall end at the close of each of the first, second, third and fourth years from the establishment of the Bank. Subject to this, the term of office of the Directors shall be five years, but they may be reappointed."

Any casual vacancy shall be filled in the same manner as prescribed for original appointment. The Directors shall elect a chairman annually from their own number. For ordinary decisions, including those involving elections, a simple majority is enough; but in other cases, *e.g.*, in the case of an amendment of the statutes, etc., a two-thirds majority shall be required.

The Paris experts, anxious to safeguard the independence of the Bank from political influence, declared that the functions of Directors were incompatible with those involving national political responsibilities. The composition of the Board gives the seven original countries a voting strength greater than their participation in the share capital of the Bank. Though they get 56 per cent. of the shares, they have obtained 16 seats out of 25 on the Board which comes to 64 per cent. of the votes, excluding the casting vote of the Chairman. The interests of the small participants are not sacrificed, because there is seldom unanimity among the seven original countries when questions of importance are involved. Further, in case of decisions of importance, a majority of two-thirds is required, and the sixteen Directors representing the seven principal countries, even if unanimous, will have to obtain the support of at least one Director representing smaller holders to obtain the necessary two-thirds majority once the number of Directors reaches the statutory figure of twenty-five.

SHARE CAPITAL

The share capital was fixed at the equivalent of \$100,000,000, of which 25 per cent. was to be paid up. This comes to £5,000,000. The distribution of shares is such that the control is retained in the hands of the seven principal countries responsible for the scheme. Other participants may include countries interested in reparations and countries on a gold or gold exchange basis, but their total interest can never exceed 44 per cent. of the share capital. The central banks can pass on the shares to the general public after having subscribed them, but they retain the voting rights attached to the shares.

It may be pointed out that the Board was not meant to consist exclusively of bankers, but might include the representatives of industry and commerce.

DEPOSITS

The Bank is entitled to receive deposits of the following categories :—

- (1) deposits on annuity account from the creditor Governments ;
- (2) deposits on clearing accounts from central banks, consisting of gold ;
- (3) deposits in connection with the Bank's reparations functions ; and
- (4) a special deposit from the German Government.

The Bank can pay interest on deposits not liable to withdrawal except on one month's notice, and its rate of interest varies according to the nature of deposits.

Part VI of the Young Report enumerates the operations which the Bank can undertake. The Board of Directors is entitled at its discretion to include others. There is a clause which entitles the central banks to veto any transaction of the Bank in their currency or with their country. The Bank can buy and sell gold coin and bullion, which probably means that the authors of the scheme had in mind the establishment of a gold reserve. It can earmark gold on account of central banks, which shows an idea of the establishment of international gold clearing. The Bank can deal in bills and other short-term obligations. It may open deposit accounts with central banks, re-discount bills presented by central banks, make advances to central banks on security and buy and sell long-term securities other than shares. It may issue obligations which have investments in Germany as collateral security, or other long or short-term obligations of its own. The Bank is,

however, forbidden from acquiring a predominant control over business interests in any country.

The Bank can perform certain agency functions, either on behalf of central banks, or on behalf of creditor Governments which desire to mobilize their share of the reparations bonds. Its relations with central banks are based on the principle of reciprocity. In regard to the mobilization of annuities, the Bank is to advise the Governments whether the moment is opportune for such operations. If a creditor Government wants to issue reparations bonds in its own market only, the task of the Bank is confined to the creation of the bonds, while the particular Government concerned handles the operation.

The Young Plan laid down certain minimum reserve requirements which were not embodied in the Bank's Statutes. The percentage fixed by the Young Report is 40 and 25 for sight liabilities and time deposits respectively. The Bank for International Settlements not being a bank of issue, there is no necessity to fix a minimum reserve ratio. Further, the reserve may include, in addition to gold, short-dated securities in gold currencies. The fixing, therefore, of a minimum ratio does not seem to have any useful purpose, because in any case the Bank is obliged to hold practically all its assets in the shape of such securities.

DISTRIBUTION OF PROFITS

According to Part XI of the Young Plan the shareholders are entitled to a cumulative dividend of 6 per cent., and the maximum dividend they can expect is 12 per cent. After making good provision for reserves, the remaining net profits are to be used, to the extent of 75 per cent. to remunerate the time deposits of the Governments or central banks of the creditor countries or Germany, and to the extent of 25 per cent. to accumulate a special fund for the reduction of the last 22 German annuities, provided that Germany deposits with the Bank 400,000,000 Reichsmarks.

STATUTES OF THE BANK

The Organizing Committee which met at Baden-Baden in October, 1929, framed the statutes of the Bank for International Settlements. It had to settle the highly controversial question relating to the location of the Bank and after great discussion a neutral place, Basle in Switzerland, was selected as the place of the location of the Bank. Although London possessed the most suitable requirements for being a centre of location, it was opposed by the French representatives at the Hague Conference. The requirements of such a centre are the following:—

"(1) It should be a financial centre of some importance, with lively international banking activity.

(2) It should possess a good foreign exchange market, with adequate facilities to transact business in every important currency.

(3) It should possess a good gold market, with ample supplies and a regular demand, and a complete freedom of gold movements.

(4) It should possess a good bill market.

(5) Its geographical position should be advantageous, with special regard to the intercourse with New York."

London, at the time of the establishment of the Bank for International Settlements, satisfied these requirements to a greater extent than any other centre; but purely financial considerations did not prevail and ultimately Basle was selected as a matter of compromise. In this connection the Young Report stated that the Bank "....shall be located in a financial centre hereafter to be designated. In selecting the country of incorporation due consideration shall be given to obtaining powers sufficiently broad to enable it to perform its functions with requisite freedom and with suitable immunities from taxation." Needless to say that any country would have been prepared to give sufficiently broad powers to the Bank in this connection, because the country of location would have obtained a great financial prestige by the existence of the Bank within its borders.

Another important question before the Organizing Committee was whether the Board of the Bank should be given a comparatively free hand or the scope of the institution should be clearly defined. The scheme being without precedent, it was not possible to draft hard-and-fast rules regarding the exact sphere of the activity of the Bank. The rules were expected to grow from the experience of the institution.

Vested interests, however, feared that the Bank would become a formidable rival to them. The Young Report had emphasized that it would not interfere with the functions performed by the existing institutions, but this was not sufficient to put confidence into the existing banking interests which claimed more specific guarantees against the competition of the new Bank.

The inclusion of a clause in the statutes to the effect that the Bank should not compete with the existing institutions would have paralysed its activities altogether. Certain clauses have, however, been included which offer safeguards against competition. The statutes differ from the Young Plan inasmuch as they debar the Bank from undertaking certain types

of transactions. The Bank is debarred by the statutes from carrying on the following business :—

(1) It cannot issue bank notes payable to bearer.

(2) It is forbidden to undertake acceptance business. This was meant to reassure the acceptance houses, because acceptance business is probably the most competitive branch of banking. Further, the authority of granting acceptance credits would open immense possibilities of credit inflation. This prohibition does not in any way handicap the Bank's normal activities, because its object is to re-discount bills from the portfolios of the central banks and not to create a volume of additional bills.

It does not, however, mean that the exclusion of the Bank from the acceptance business can prevent it from competing with banks in the financing of foreign trade. The Bank can establish contact with foreign banks with the permission of the central banks concerned, and thus it can discount their bills. The Bank, therefore, can finance foreign trade by discounting bills, diverting business thereby from acceptance houses. The Bank would not, however, resort to such direct competition and it can give all the support required through the central banks concerned. The result is, however, the same : "for if they enable the central banks to finance a larger portion of the foreign trade of their countries, they divert thereby business which would normally have found its way to acceptance houses and to banks engaged in acceptance business."

Thus the restriction preventing the Bank from granting acceptance credits is more apparent than real. The ultimate result is the same whether the Bank grants direct acceptance credits or it re-discounts bills held by central banks, enabling them to increase, in turn, the limit of re-discounting facilities granted to the banks in their countries. But this competition is less aggressive and is likely to provoke less hostility on the part of vested interests. The Board of the Bank is to use its powers with discretion. The primary object of the Bank is not to provide for a more equal distribution of the world's financial resources, but to support a currency in case of emergency. In doing so the Bank cannot help competing to some extent with banking interests ; but it is not justifiable to go further than is necessary to maintain international monetary stability.

(3) The Bank is not allowed to establish any relations with Governments other than those originating from its rôle in connection with reparations. It cannot open current accounts for Governments, though it can open time deposit accounts. It is not allowed to grant loans to Governments,

but it can discount Treasury Bills and other short-term obligations of Governments. It can also grant loans to central banks on the security of short-term Treasury Bills. The central banks can veto any transactions with the Government of their country, and thus the Bank can be prevented from taking an interest in the financing of Governments.

(4) The original Young Report imposed a restriction on the acquisition of the control of any business interests in any country. The statutes amplified this restriction by a clause which prohibits the acquisition of real property other than that required for the Bank's own purposes.

(5) The right of central banks to veto any transaction in their country or in their currency which was granted under the Young Report has been modified by the statutes. If the veto had been left unrestricted, any central bank could object to the withdrawal of funds invested by the Bank in its country, which would immobilize the resources of the Bank. The veto is useful when the central bank of a country is anxious to maintain tight money conditions. Of course, it would be seldom that a central bank would object to the inflow of funds. It may also be used with advantage to prevent the Bank from investing its funds in certain types of securities.

The Bank can enter into arrangements with central banks which authorise the former to carry out certain types of business without the latter's specific permission.

(6) The statutes unlike the Young Report do not provide for a minimum percentage of reserve ratio on sight liabilities and time deposits. The Bank not being a bank of issue does not require to keep a minimum reserve ratio. "From a practical point of view, as the minimum reserve may include, apart from gold, any short-term claims in approved currencies, there was no object in fixing a minimum percentage, as the Bank has to keep almost all its assets in such form that its 'reserve' is not much short of 100 per cent. in any case. It would make a considerable difference if part of the reserve had to be kept in gold. But such a measure would be highly undesirable both from the point of view of general interests—as it would accentuate the scramble for gold—and from the point of view of the Bank's earning capacity..... The decision of the Organizing Committee to waive the minimum reserve requirements was, therefore, fully justified."

The statutes emphasise the necessity of maintaining the Bank's liquidity and the assets which may be considered liquid are enumerated. It is also laid down that, in determining the proportion of the Bank's assets which may be invested in any particular currency, the Board should pay due regard to the distribution of the liabilities of the Bank.

The international character of the Bank is emphasized. There has been a desire to include the greatest possible number of central banks as shareholders and the Board has been empowered to include additional central banks with full voting rights on the occasion of future capital increases. The statutes curtailed to a great extent the powers of the Board of Directors, on which reparation powers have a stronger representation than at the shareholders' meeting by depriving them of their authority to alter statutes. According to the Young Plan, vacancies on the Board were to be filled by the nominees of the representatives of the seven founder banks only, but according to the statutes the decision rests with the whole Board.

The Bank's statutes were passed at the Hague Conference of January 1930.

CREDIT RESOURCES

The actual and potential credit resources of the Bank may be enumerated as follows:—

- (1) Its paid-up capital amounting to 125,000,000 Swiss Francs (under £ 5,000,000).
- (2) Its callable capital. The authorised total of 500,000,000 Swiss Francs is subscribed by central banks and guaranteed by the seven founder banks. The uncalled capital is thus an asset of absolute certainty.
- (3) Reparations annuities held until their distribution to the creditors.
- (4) The German Government's non-interest-bearing deposits amounting to about 100,000,000 Reichsmarks.
- (5) Other Government deposits under the Young Plan.
- (6) The non-interest-bearing deposit of 125,000,000 Reichsmarks which belongs to the creditor Governments.
- (7) Central banks deposits and/or current account balances.

The Bank possesses immense possibilities to expand credit over and above these resources. According to the statutes it is debarred from granting acceptance credit, yet in the long run the Bank may be able "to increase its resources to an extent that is entirely without precedent in the history of commercial banking. It can do so in the pursuance of its normal functions of making advances to and receiving deposits from its customers, the central banks."

A commercial bank can increase the amount of the advances it grants to its customers. A part of the amount granted by it is left on deposit with the bank. A part of the rest which

goes into circulation returns to the bank, a greater part of which can be re-lent over and over again, and the process results in a marked increase of the total amount of deposits held by the bank. The Bank for International Settlements can also grant loans to central banks on specified securities and the unused balance of the loans will increase its total resources. As in the case of commercial banks, the same amount can be re-lent many times, which must increase the total resources of the Bank.

The Bank for International Settlements has an advantage over other commercial banks in this respect. The expansion of the resources of the latter is limited by the necessity of maintaining a certain ratio of cash to deposits. The amount of cash, including gold, notes and balances with the central bank, is determined by the credit position and gold resources of the central institution. Commercial banks thus cannot increase their resources beyond a certain amount. Such a limitation does not apply in the case of the Bank for International Settlements. Its cash resources include its balances with central banks, which constitute a very large proportion of its assets. Its liquid assets also include all its holdings of short-term bills according to the statutes. Thus the increase of its deposits brought about by the granting of fresh advances also increases its liquid assets almost to the same extent, which, in turn, would enable the Bank to grant fresh advances by a multiple of the increase. "The process has all the characteristics of an avalanche, unless checked in time by inherently sound management and conservative principles." It may be said that the Bank would only grant advances on good security, but a central bank can easily provide security which can satisfy the Bank. Any commercial bills endorsed by a central bank will pass on as good security. Central banks can also offer a part of their gold or foreign exchange reserves as security for advances from the Bank. It may be anomalous that the same gold or foreign exchange reserves serve as security for notes also, but according to their statutes many central banks can make double use of their resources. "In theory, these central banks would be able to increase their note circulation almost indefinitely by obtaining an advance from the Bank, depositing with it the securities acquired with the aid of the foreign currency thus obtained, raising on the security another advance and repeating this process *ad infinitum*."

It may be pointed out that this question of the inflationary possibilities is of an academic interest only; because the setback in the development of the Bank caused by the crisis has eliminated such possibilities for a long time to come. The crisis has very much reduced the credit resources of the Bank.

The goodwill of most participating central banks has also suffered and it is very likely that the management of the Bank will be very cautious in its loans policy in future.

THE BANK AND WORLD PRICES

In course of time after the crisis is over, the Bank would be able to exercise a powerful influence in the movements of world prices. This does not, however, mean that the Bank for International Settlements may become the sole institution in course of time, having the power of influencing international price-level. Apart from the natural and artificial causes of price movements, the conflicting influences of central banks will also continue to exist; but the Bank for International Settlements may have a moderating influence upon them. For a long time after the crisis, it will be too fully occupied with the problems of its own consolidation to embark upon ambitious experiments; but sooner or later, it may be in a position to assume the rôle of the principal authority regulating the international price level.

When price disturbances are caused by monetary causes, the intervention on the part of the Bank for International Settlements would be desirable. The aim of the Bank should be to enable the international banking system to maintain an adequate volume of credit in spite of the inadequacy of the volume of gold.

This object can be achieved in several ways:—

"(1) The Bank can avoid deflation by arranging a systematic distribution of gold between central banks, thereby preventing excessive demand by some of them.

(2) Should it fail to achieve this end, it can prevent the contraction of credit caused by a scramble for gold by means of bringing about an extension of international credit resources.

(3) By its mere existence it can make the same amount of gold serve as a basis for a larger volume of credit."

The principal aim of the co-operation between central banks has been to moderate the appetite of some of them for gold and to prevent a fall in prices due to excessive demand for gold. This object can be better achieved through the medium of the Bank for International Settlements than through informal co-operation.

The Bank can enable central banks to make a fuller use of their gold resources than has been the case so far. Central banks have hitherto tried to accumulate a safety margin over and above the legal minimum ratio to satisfy a fluctuating demand. If the Bank for International Settlements is in a position to support the central banks, the latter would be able

to dispense with the maintenance of the safety margin. The legal minimum ratio could also be lowered, because in case of emergency the central banks would be able to fall back upon the Bank for International Settlements.

It should, however, be emphasized that, even after the restoration of normal conditions, the Bank will never be able to acquire a predominant influence over world price movements without whole-hearted co-operation between the leading central banks.

INTEREST RATE

There is no provision in the statutes or the Young Report for the manner in which the Bank for International Settlements is to fix its rates of interest. This is, of course, a matter for the Board of Directors to decide, who should fix the re-discount rate and the rate of advances to meet the particular circumstances of each individual case, taking into consideration the rate at which the Bank itself can borrow in the same currency. The management has, therefore, to follow closely the development in every money market and to investigate the position of every central bank. Commercial banks also have no uniform rates for their customers, and their terms vary according to the financial standing of their customers, the nature of the security, etc. The Bank for International Settlements also in the past had to resort to a similar practice.

The idea of a "world bank rate" in the sense of a uniform rate to be applied indiscriminately is impracticable. The conditions of security and the rates of interest prevailing in the countries concerned have got to be taken into consideration in fixing the Bank Rate by the Bank for International Settlements.

It may be suggested that the re-discount rate may be fixed by the Bank on the basis of the official bank rate of the prospective borrower. The question then is whether the re-discount rate should be equal to, higher or lower than, the bank rates of the countries concerned. This principle is highly questionable, because central banks requiring the assistance of the Bank would be tempted to keep their bank rates at a low level which would result in the efflux of foreign capital. The Bank for International Settlements would then become the cheapest lender. The evil consequences of this policy would be accentuated if the re-discount rate were to be fixed at a lower rate than the Bank rate of the borrowing countries.

Another aspect of the problem is the general movement of these rates over a period of time. The Bank is naturally under the influence of international trend, and an all-round change of bank rates is bound to affect the lending rates of

the Bank accordingly. The position of the Bank itself is also a factor of great importance. A slack demand for loans would justify a lowering of re-discount rates ; while if there is a strong demand and the Bank is already over-lent, one of the means of discouraging further borrowing would be to raise the rates. This is the main reason why the re-discount rate of the Bank cannot bear any fixed ratio to the bank rates of the borrowing central banks.

It may be pointed out that the bank rate policy of the Bank would not always be a passive factor. It should not be supposed that its re-discount rate policy will consist in the adjustment of its rates to changed circumstances. The Bank may play an active part in influencing tendencies in the international money market with control of the international price-level as one of its most important objects. The changes in its discount rates may be the cause of corresponding changes in general tendencies and need not always be their effect.

INTERNATIONAL GOLD CLEARING

An important object of the establishment of the Bank was to bring about an international gold clearing system to reduce the unnecessary gold shipments. It was believed that the preliminary condition of such a system would be the establishment of an international central gold reserve. The President of the Bank for International Settlements remarked in this connection that "Our statutes provide not only for operations in foreign exchange but also for the creation of an adjustment fund for movements in gold. A study of the possibility is under way and the Bank for International Settlements has already received gold deposits from certain central banks and is in a position to transfer them from the account of one bank to another. If and as more central banks adopt this system, we should avoid a recurrence of incidents like those witnessed in recent years, when gold crossed the Atlantic from London to New York at the same time that gold was transported from New York to Paris."³

The establishment of an international central gold reserve has not so far been possible, because confidence in international relations has not been sufficiently established. Most central banks are anxious to repatriate the major part of their gold holdings abroad at the earliest opportunity. They would not contribute any large amounts of gold towards an international reserve, even if it were to be held in a neutral country.

The statutes authorise the Bank to accept from central banks gold in deposit, and to deposit gold with central banks.

³ See Remarks of the President of the Bank for International Settlements, before the American Club of Paris—February 12, 1931, English Version.

Thus the contribution of a central bank to the international gold clearing fund need not be removed to the headquarters of the Bank for International Settlements ; but may be kept in deposit with the central bank itself. For instance, if the Bank of England has to transfer gold to the Bank of France, the Bank for International Settlements reduces the amount ear-marked on account of the former and increases the amount ear-marked on account of the latter. Every six months or annually a balance of claims and counter-claims would be struck and if necessary the difference would be shipped.

The objects for which the system is to be used are the following :—

- (1) To obtain the monopoly of gold shipments for the Bank and the participating central banks.
- (2) To reduce the physical movements of gold to a minimum across the frontiers.
- (3) To avoid superfluous shipments in connection with special transactions.

POLITICAL ASPECTS

It is very necessary that the Bank for International Settlements should pursue a neutral policy in respect of political matters. When dealing with its political aspects, its functions may be divided into reparations payments and its international banking activities. Regarding the former, the rights and duties of the Bank are strictly defined by the statutes and the Young Plan. As depository of reparations funds all the Bank had to do was to collect the amounts transferred by the German Government and distribute them among the creditor Governments, after having retained the amounts due for the service of the External Loan of 1924 and the remuneration of its services. There was, however, a wider scope for political influences in the case of the mobilization of the annuities.

Regarding its international banking activities it is pointed out that the Bank for International Settlements " has become one of the battlefields in the financial warfare which has been conducted by France for political ends."⁴ M. Quesnay's proposal at the Baden-Baden meeting of the Organizing Committee for the creation of a new monetary unit, the grammon to serve as unit of account of the Bank for International Settlements ; the case of the Yugoslav stabilization scheme, when the stabilization loan was concluded with the French banking group, etc., are given as characteristic examples of the way in which the Bank was used for the support of French interests. During

⁴ For details, see Dr. Paul Einzig, *Bank for International Settlements*, Chapter XIV, Third Edition.

the last financial crisis, French influence has considerably increased and in spite of the minority on the Board, French interests have practically obtained control. "In January, 1932, the Board of Directors decided that it would agree to the renewal of its participation in the credit of \$ 100,000,000 granted to the Reichsbank in July 1931, only on condition that the three participating central banks would agree to a renewal. It was an open secret that French interests wanted to make use of this credit to bring political pressure to bear upon Germany."⁵

There is the possibility that in course of time the Directors of the Bank would detach themselves from the nation which delegated them, and might regard themselves as true citizens of the world, whose judgment would be independent of the political views of their own nations. The Bank would then become the arbitrator between nations in economic, financial and political matters. But this is merely an idle dream, because what the League of Nations could not achieve, the Bank cannot hope to achieve. Even if it were so, the Bank should not interfere with politics. Of course, if political conditions in a country are so disturbed that it is unsafe to lend money to it, then—and only then—the Bank would be justified in using discrimination against that country.

Neither the Young Plan nor the statutes made any provision as to how the Bank should deal with the situation in case of war. It is, however, necessary that the Bank should not grant credit to the central bank of a belligerent country. No credits should be granted unless secured by gold or some equivalent security. It should pay out any deposits it holds on behalf of either party should they want to withdraw them and may also accept fresh deposits. This would be in accordance with prudent banking.

LIMITATIONS OF THE BANK

(1) *Inadequate Co-operation.*—Those who expected that the Bank would create a new era of prosperity were disillusioned because of inadequate co-operation. It has not been possible for the Bank to secure co-operation of conflicting international interests for the common good. No doubt the Bank provides an ideal channel for co-operation; but its mere existence in itself does not secure co-operation any more than the existence of the League secures co-operation in politics. "Inadequate co-operation has been one of the main reasons why the Bank has so far been unable to satisfy even modest expectations."

⁵ See *Ibid.*, page 124.

(2) "The hopes attached to the advantages of personal intercourse established between central banks through the Bank for International Settlements have not materialised." Cordial relations have not been established at the Board meetings. As a result of the compulsory attendance at monthly meetings, the members had to discuss controversial questions which further widened the breach between them.

(3) The hopes that the Bank would be able to assist Germany in carrying out the Young Plan have not been realized. The Young annuities were absolutely beyond Germany's capacity, and even if the crisis had occurred a decade later the Bank would not have been able to save the Young Plan even if it had possessed far greater resources; because the Plan was based on an entire disregard of realities.

(4) The Bank has not been able to prevent the suspension of the gold standard in a large number of countries, and thus the stabilization programme which was one of its main objects has not been realized. But it would be unfair to blame the Bank for this factor, because the Bank's total resources were never very large.

(5) The expectation that the Bank would be able to prevent the maldistribution of gold has not been realized. Genuine co-operation only would have secured a more equal distribution of gold, but it has not been forthcoming.

(6) The Bank has not been able to arrest the fall of world prices; but it would be unreasonable to blame the Bank for not having been able to achieve this object. In its early stage of development, it would not have been able even to attempt to influence world prices. Whole-hearted co-operation of central banks as to the policy to be pursued is necessary before this object can be achieved. The banks possessing surplus gold must be able to place it at the disposal of the Bank before it can influence world prices. But the fact that the Bank has not been able to do so should not be regarded a proof of its inability to do so. Its limitation in this respect can be overcome by good-will and genuine co-operation.

(7) The attempts of the Bank at the establishment of international gold clearing and international exchange clearing have remained within modest limits. These schemes could not have been expected to develop into organizations of first-rate importance even if their development had not been checked by the crisis. The complete elimination of the physical displacement of gold is neither possible nor even desirable.

(8) *The Question of Personnel.*—An important question is whether the Bank can overcome its limitations regarding an adequate personnel capable of managing the financial destinies

of the world. Appointments may be made for political rather than for banking considerations. The foreign exchange department of the Bank often received instructions to carry out operations of considerable magnitude on short notice. Such operations must be spread over a number of days at least, so as to avoid disturbing the market and to secure favourable exchange rates. Little heed, however, was paid to such points of technical detail in the past.

THE BANK IN OPERATION

The Inaugural Board meeting of the Bank was held in May 1930. The Board consisted of the representatives of the seven founder countries, each of whom appointed two members, while France and Germany were represented by three members each. M. Quesnay was appointed as the General Manager of the Bank, though his appointment met strong opposition from the German side. The office of the Deputy General Manager went to Germany.

The subscription of the initial capital was completed during May and each of the seven founder countries was allotted 12,500 shares of 500 Swiss Francs nominal. There was no uniform policy as to the way in which the banking groups or the central banks should handle their shares. According to the statutes they could part with shares without parting with voting rights. It was only in France that the shares were offered for public subscription. Further shares were allotted to central banks which had established relations with the Bank for International Settlements. On March 31, 1931, 23 shareholding institutions of different nationalities were the shareholders of the Bank and the total number of shares was 112,000, with a total of 165,100 shares outstanding, in addition to which 6,000 shares were authorized for delivery to the central banks of Yugoslavia and Portugal when their currencies were stabilized.⁶

The first task of the Bank was to make arrangements for the issue of the Young Loan, representing the commercialization and mobilization of part of the unconditional annuities under the Young Plan. Generally speaking, this loan could not be regarded as successful. Conditions in the international loan market were not favourable to the transaction, and in many countries the investing public remained aloof owing to the political nature of the loan. The Bank was not, of course, financially responsible for this transaction.

The organization of the administrative apparatus of the Bank was not easy, because nobody knew what the requirements of its functions could possibly be. Its internal organization had, therefore, to be changed on several occasions. Its

⁶ First Annual Report of the Bank, Basle, May 19, 1931, page 1.

main departments were the reparations section dealing with the functions arising out of the Young Plan, the banking section dealing with foreign exchange, deposits, investments, etc., and the central banking section in charge of the Bank's relations with central banks.

There was a steady increase in the number of central banks participating in its activities. Only countries on a gold basis and those interested in reparations were eligible according to the statutes to purchase the Bank's share capital. By the middle of 1931 almost all European central banks on a gold basis had established an account with the Bank.

Many ambitious schemes were put up before the Board, but they could not be carried through. This does not mean that the Bank did not make its presence felt in international banking. It has laid the foundations of developments which in normal conditions may become of great importance. The Bank has become the trustee of the Young Loan, it has been put in charge of the services of the Austrian loan of 1931 and arrangements were being made to make it the trustee of various international mortgage loans and other issues.

The Bank introduced clearing arrangements between various Treasuries. Before these arrangements, Germany paid over the reparations through the Reparations Commission to the creditor Governments, which in turn made arrangements for getting dollar or sterling to pay their war-debt annuities. The Bank for International Settlements is now able to offset certain transactions, being in charge of transferring both, reparations and war-debts.

The Bank is not allowed to grant medium-term credits or agricultural credits to any great extent; but it does provide its normal support in such cases by minor participations in the share and bond issues of international mortgage institutions.

It was to assist central banks in stabilizing their currencies and it assisted a number of European central banks in this respect before the crisis. It took active participation in the Yugoslav stabilization scheme, though the stabilization of the Spanish peseta had to be postponed owing to the political upheaval in that country.

In conjunction with other central banks, it granted a credit of \$ 108,000,000 to the Reichsbank in 1931, in which it participated to the extent of \$ 25,000,000. Its resources became immobilized as a result of these transactions and they also declined as a result of the Hoover Moratorium which deprived the Bank of Treasury balances pending their distribution to creditors. Since July 1931, the Bank has not been in a

position to give powerful help to anybody. Disagreement between the principal Governments has made it impossible for the Bank to extend help to end the crisis. In the autumn of 1931, attempts were made to make arrangements for removing the difficulties arising from exchange restrictions, but to no effect.

The suspension of the gold standard did not mean any direct losses to the Bank, because its sterling balances were moderate and were covered by sterling liabilities, while its assets in other depreciated currencies were negligible. It made attempts to induce the central governments to guarantee the gold value of the deposits of the Bank for International Settlements which the former refused to do. As a result the Bank itself could not guarantee the gold value of the deposits of central banks.

ITS FUTURE

So far the Bank has been a disappointment and at present its position and prospects are not bright. Its resources have been reduced and immobilized, and it is reduced to impotence in face of the crisis as a result of disagreement between the Governments of the countries participating in the Bank. In spite of its limitations and shortcomings, the Bank has rendered useful services in the past and is capable of rendering further services in the future. It cannot be expected to settle matters on which Governments themselves disagree. When the politicians come to terms as to co-operation, the Bank will be of great practical use.

The authors of the scheme wanted to make it a permanent international financial organization. Though at present the world crisis overshadows everything, its significance in the Bank's history may be reduced to that of an episode if the Bank continues to exist. The objects of the Bank are:—

(1) to assist in promoting and simplifying the international flow of capital and the development of new facilities for international financial operations;

(2) to assist in the simplification of international settlement of accounts between one country and another and between one currency and another, e.g., the service of international loans floated in several markets of the world, and the payments from one national economy to another of the net balances arising out of commercial and financial transactions;

(3) to introduce economy of gold use and the creation of an adjustment fund for movements in gold;

(4) to promote stabilization programmes;

(5) to act as trustee for Government loans;

- (6) to move capital from markets of low interest rates to markets of high interest rates in order to help the trend towards a levelling out of rates and to assist commerce and agriculture in places where the interest rate is high ;
- (7) to organize credit mechanism in centres where necessary instruments of credit are lacking ; and
- (8) to provide opportunity for central banks to discuss together their common problems.

"The B.I.S. is an institution whose direction from the start shall be co-operative and international in character ; whose members shall engage themselves to banish the atmosphere of the war, to obliterate its animosities, its partisanship, its tendentious phrases ; and to work together for a common end in a spirit of mutual interest and good-will."

In view of these objects and the services rendered by the Bank in the past, it may be said that if it is given a fair chance gradually to develop its resources and perfect its organization, it is likely to create for itself an extremely useful and valuable sphere of activity. In course of time, it may become an indispensable part of the international financial system, just as the Bank of England has become an indispensable part of the British financial system. The Bank should not, therefore, be sacrificed to a short-sighted policy whose aim may be to obtain ephemeral political advantages. It is the duty of those at the helm of affairs of the Bank to see that no one country, however strongly it may be represented financially on the Board of Management of the Bank, should be able to use the Bank for its own political ends.

CHAPTER XXIV

Trade Depression

TRADE depression has overshadowed every human activity and as it has progressed and deepened, it has taken within its fold a larger number of industries. There is no branch of economic or social activity of mankind that has not been affected by it. Decline of prices, increase in unemployment, fall in wages, accumulation of stocks with producers and businessmen, failure of banks and businesses and fall in the volume of inland and foreign trade are its main symptoms.

It is very difficult to fix the date of an economic crisis because it is the result of the slowly moving forces and gradually working tendencies. The decline of price level cannot in itself be called a crisis unless the rate of decline reaches a certain point of acuteness when eventually it may be accentuated into a crisis. The crisis can be judged by an increase in unemployment, but it cannot be easily said at what point has the depression developed into a crisis. It is, however, fairly certain at present that the depression has assumed the form of an acute type of crisis. The Wall Street Slump of October 1929 may be called as the starting point of the present crisis because though the lull in prices and in the trade of the world had begun earlier, the Wall Street Crash was an event of so great an importance as to be regarded a landmark in the economic history of the post-war period. It was about a year after the Wall Street collapse that people could realize that they were in the midst of an acute type of depression.

Agriculture was the first industry to be hit hardest by it. The technical improvements of the post-war period reduced the cost of production and the crisis was precipitated by over-production. It came like a bolt from the blue on the agricultural industry. The demand for industrial products fell considerably as agriculturists could not purchase machinery and other products. It very soon spread into the domain of industrial production also. This meant a decline in the demand for the products of the various extractive industries which further reacted upon the latter. The fall of the purchasing power of the agricultural population further accentuated industrial depression and the vicious circle was thereby completed.

In 1931 there were a series of cataclysms in the sphere of finance which showed that it was much deeper than the crises of 1907 and 1921. The gold standard which had been

re-established with great difficulty in the decade following the armistice broke down completely under its strain. Credit collapsed, confidence diminished further and foreign lending ceased for all practical purposes. Businesses became hazardous because of currency fluctuations which added to the intensity and acuteness of price fluctuations. Restrictions on trade and foreign exchanges were multiplied by the governments to safeguard the balance of their payments upon which the stability of their currencies depended. Protection was adopted as the general policy which meant that people were discouraged from purchasing foreign goods. This led to a fall in foreign trade which increased unemployment. Financial, economic and social security fell which produced psychological disturbances and the resultant doubts and fears bred political unrest.¹

INDICES OF THE CRISIS

The index of wholesale prices shows the extent of the crisis. According to the Report of the Director of the International Labour Conference for 1933, "the levels (of prices)

¹ The President of the World Economic Conference, Mr. Ramsay MacDonald, Prime Minister of the United Kingdom, in his address to the Conference, said:—

"The economic life of the world has for years been suffering from a decline which has closed factories, limited employment, reduced standards of living, brought some States to the verge of bankruptcy, and inflicted upon others recurring budgets that cannot be balanced. The machinery of international commerce, upon which the vigour of the human life of the world and the prosperity of nations depend, has been steadily slowed up. The markets are there, the labour to supply them is there, but the labour is not employed and the markets are not filled. When we had a less efficient equipment for the making of wealth, our national incomes were greater. All the machinery of prosperity is there. But it is slowing down; it is not working.

"The briefest reference to the astounding facts will show the magnitude of the problems before us and at the same time direct our thoughts to the points of attack. Since 1929, prices have fallen and have kept well below levels at which production can be remunerative. They have fallen irregularly, moreover, and have distorted the normal relationships upon which economic activity is pivoted. The fall in prices has added oppressively to the burden of world indebtedness. In 1932, compared with 1929, the production of raw materials has fallen 30 per cent., and the exchange between town and country has been tragically limited. National income has fallen seriously everywhere—in some countries by 40 and 50 per cent. The general crisis, accentuated by restrictions, by tariffs, quotas, exchange control, has reduced international trade between 1929 and 1932 to less than three-quarters in volume exchanging at about half the price. The gold standard has had to be deserted more generally than has been the case in time of peace since it was erected into the international measure of exchange. And inevitably, irrespective of fiscal policy and of forms of government, unemployment has mounted up until the world figure issued by the International Labour Office has reached 30,000,000." (See the *Monthly Summary of the League of Nations* for June, 1933, pp. 137 and 138.)

reached in many cases were without precedent in modern times, particularly in that of wheat, which in December last was cheaper than at any time since the sixteenth century."²

Another index of the crisis is the volume and value of the international trade. The decline has naturally been sharper in value than in volume because of continually falling prices. According to the Draft Annotated Agenda submitted to the World Economic Conference by the Commission of Experts, "the international flow of goods, hindered by currency disorders and restricted by a multiplicity of new governmental interventions, has been reduced to incredibly low levels. The total value of world trade in the third quarter of 1932 was only about one-third of the corresponding period of 1929. Moreover, the quantum of goods in foreign trade appears to have fallen by at least 25 per cent.; by far the largest fall on record."

The index of production confirms the dark picture presented by prices and international trade. The output of consumers' goods increased somewhat without any corresponding movement of consumption, "with the result that it now seems to have exhausted itself." Manufacturing production cannot improve so long as there is no improvement in the purchasing power of the masses dependent on industry and agriculture. In other words, without an increase in the prices of foodstuffs and raw materials, the farmer and miner cannot purchase their normal share of industrial products and without demand for producers' goods, industrial population cannot purchase their normal share of agricultural and manufactured products.

Recovery is impossible without an increase in commodity prices and this cannot be achieved until money and credit begin to circulate more freely. In the sphere of finance, budgetary difficulties, the immensely increased burden of private and public debt, the cessation of international lending and the rapid fall of national and individual incomes can be discerned. The recent collapse of the American banking system has thrown back for a time at least the faint efforts towards recovery.

Under the circumstances there is little evidence of any general tendency towards fresh investment. During the last few years deposits continued to accumulate and in spite of a fall in the rates of interest in many countries, there was little demand for money and banks were reluctant to furnish credit to new enterprises. The investors are lacking in the necessary confidence to invest their savings in new ventures. Further,

² See League of Nations, *World Economic Survey, 1931-1932*, pp. 223-224, Geneva, 1932.

there is the widespread apprehension of the political situation in Europe, South America and the Far East which has further aggravated the acuteness and intensity of the crisis by adding to the forces of want of confidence caused by the financial and economic confusion. The cessation of international lending is due to political apprehensions to a very large extent. In the words of the Director of the International Labour Conference for 1933, "As long as armed conflicts continue, and the danger of a new pace in armaments with the prospect of future conflagrations persists, is any general revival of the world's prosperity to be anticipated? Although these political upheavals are in a large measure the outcome of the economic disorders from which humanity is suffering, they have now become a major obstacle in the way of any effective action towards general recovery."

The Preparatory Commission for the Economic Conference pointed out that economic salvation cannot be achieved except by whole-hearted and extensive international co-operation. The latter is unthinkable as long as national rivalries are being fostered. The words of the Commission may be usefully quoted here:—

"What is needed is a comprehensive programme of world reconstruction and this should be carried through as rapidly as possible, so as to strengthen the forces which are now working towards recovery. We have here presented such a programme.... If the Governments are prepared to undertake it, and also to settle political questions which lie outside the Conference, we believe that confidence and prosperity can be restored."

SOCIAL ASPECTS OF THE DEPRESSION

The world is passing through a period of unprecedentedly acute unemployment with all its untold misery, the waste of talent and energy, and the frustration of hope which it entails. Under the modern capitalistic system, the worker usually lacks sufficiency, security and certainty, a fact which has now been aggravated manifold. There is an imperative demand for work on the part of the worker and all other considerations pale into insignificance as compared with this demand, because this is the foundation of the existence of the family and of the individuality of the worker. Housing facilities, wage rates, welfare schemes, social insurance facilities and other requisites of a reasonable standard of living occupy a secondary place as compared with that of regularity and certainty of employment which should be regarded as the foremost condition of civic life. At no time in the economic history of the world has the sense of insecurity been so great as now and barring exceptional times and occasional and tem-

porary setbacks, it was generally assumed that work was available for all except a small portion; but now it has contracted to an unprecedented extent. Unemployment insurance was started with the idea of protecting the regular worker from the normal vicissitudes of industrial life which might leave him temporarily without a job. It could never be conceived as being needed to protect a quarter or a third of the industrial population against destitution. For this reason it has nowhere sufficed to meet the present situation and it has had to be supplemented by direct state aid on a large scale without which a very large number of people would have been reduced to destitution and misery.

In all countries social charges have increased. This is not the case only with those countries where there was provision against unemployment, but also in those where there was none. The state in all countries has either been subsidizing local funds or rendering direct aid to the unemployed. This has been the case at a time of unbalanced budgets entailing more taxation. The right to work which in the past has been claimed by the workers is now more generally recognized than ever before. The author of the World Economic Survey writes: "The 'right to live', if not the 'right to work', has been much more firmly established.... The widespread acceptance of the notion of 'standards of living' and the associated conception of a 'minimum standard' which society should in some way guarantee to every normal individual, is one of the most remarkable social developments of recent years.... The contractual idea which it embodies is of profound importance and marks a distinct departure from theories of individual enterprise and free competition. It establishes, in economic organization, a new social right comparable in many ways with property rights."³

The immensity of the scale of national expenditure involved in the prevailing unemployment can be gauged by the following table:—

| Country | Year | Expenditure from Unemployment Fund | Contribution of the State |
|---------------|------------|---------------------------------------|------------------------------|
| Great Britain | 1924-25 | 51 Million £ | 23 per cent. |
| | 1931-32 | 121 " " | 72 per cent. |
| Germany | 1928 | 1,071 " RM | Small portion. |
| | 1931 | 2,338 " " | 38 per cent. |
| France | 1931-32 | 652.5 " French Francs | 400 millions. |
| | | | |
| Netherlands | 1924 | 5.2 " Florins | .... |
| | 1931 | 24.9 " " | 32 per cent. |
| Switzerland | 1924 | 1.6 " Francs | .... |
| | 1931 | 37.9 " " | 84 per cent. |
| America | Sept. 1932 | 50 " Dollars | .... |

³ Report of the Director of the International Labour Conference, 17th Session, 1933, pp. 19-20.

These high social charges on unemployment benefits are one of the most prominent characteristics of the crisis. This involves two important considerations. Firstly, there is a difference between unemployment funds and national expenditure on employment. Unemployment insurance is a kind of national savings and is a kind of reserve which can be drawn upon in times of scarcity and depression. This is a sound and economic investment. When this fund is exhausted, and the unemployed people have to be supported by the state out of current taxation, the effects are different. Taxes are raised at a time when people are least able to bear them. Their capacity for spending and saving falls to a great extent and the accumulation of capital suffers and the demand also falls just at a time when depression should be resisted. The money given over to the unemployed in cash enables them to consume without increasing production. Cash payments are a less economic form of expenditure than the availability of money to furnish work in some form or other. Further, enforced idleness is very demoralizing from a human point of view. Prolonged unemployment reduces the skill of the unemployed to a vanishing point. This is becoming clearer with the development of the crisis and it is being increasingly recognized that subsidized work is better than idleness.

Public expenditure on unemployment, even though unproductive, has an economic justification and that is another aspect of the problem. The root of the crisis lies in the lack of purchasing power and the expenditure on the unemployed is a kind of compensation for the loss of purchasing power caused by unemployment. It helps to sustain the consuming market and prevents a fall in effective demand. Of course, taxation imposed on the rich classes reduces their purchasing power, but in the case of the higher incomes a smaller proportion is spent on immediate consumption than in that of the wage earner. As Professor Pigou points out in his *Economics of Welfare*, the loss of the transference of wealth from the rich to the poor is compensated by the gain to the poor by a greater amount than is suggested by the Law of Diminishing Utility.

It must, however, be admitted that unemployment insurance and assistance are mere palliatives and something better is necessary to provide work to the workers. Public works have been started in a number of countries to provide employment to the unemployed. Public enterprise is a method of stimulating production and industrial activity at a time when confidence is lacking and private enterprise is at a very low ebb. In a number of countries this has contributed towards diminishing the actual or potential mass of unemployment. In Italy, France, U.S.A., Japan, Chile and Sweden

huge sums have been spent on public works with a view to create work for the growing army of the unemployed.⁴ Public works do not provide direct employment only, but they give impetus to industry. When money is accumulating in the banks or is being hoarded because it cannot be safely invested in private enterprise, one of the most effective methods of restoring it into circulation is by loans for public enterprises. This creates demand on the part of the workers employed in the public enterprises and enables the state to mobilize a large amount of dormant capital.

Another method by which the state can provide work and stimulate enterprise is by means of subsidized employment. It can offer financial inducements to employers to widen their activity and thus employ more workers in place of giving benefits in the form of cash. This has so far been done in Germany on an experimental scale. In 1932 a series of measures to tackle with unemployment were undertaken by the State. Firstly, a credit of 750 RM was made available for various public works. Secondly, the Reichsbank declared its willingness to accept tax certificates as security for loans that it was prepared to give to assist productive enterprises. The total value of these certificates was estimated at 1,522 million RM, and if an extensive use was made of them, they were expected to give an immediate stimulus to the economic life of the country. Thirdly, an employer taking on more workers between October 1, 1932 and September 30, 1933 than he was employing in the months of June, July and August in 1932, was entitled to a bonus of 400 RM for each extra worker engaged on an average for one year. This policy was expected to subsidize the employment of 1,750,000 unemployed workers for one year. Finally, employers were authorized to increase their staffs and to reduce individual wages according to a sliding scale. The maximum reduction was not to exceed 12½ per cent. and this limit was to be reached only when the number of the workers was increased by one-fourth. This scheme had to be cancelled owing to the opposition of the workers.

Voluntary labour service subsidized by the state is another method employed by the German Government to cope with the problem of unemployment. Up to the end of February 1932, the competent authorities had approved 1,127 schemes giving temporary occupation to about 33,000 unemployed workers.

In some countries efforts are being made to provide work for the unemployed by putting them on the land by which they can grow their own food. In Germany, Great Britain,

⁴ Report of the Director of the International Labour Conference, 17th Session, 1932, pp. 23-24.

U.S.A., and Canada colonizing programmes have been undertaken to provide allotments for the unemployed to enable them to settle on the land.

CAUSES OF DEPRESSION

It is desirable to analyse the causes of depression in order to suggest suitable remedies. Maladjustment on the side of production and demand may be mentioned as an important cause of the depression. Sir J. C. Coyajee in his excellent work on *The World Economic Depression* writes: "Here the conditions have been so rapid, and so great have been the revolutions of production both on the agricultural and manufacturing sides, that by themselves they might have endangered the economic equilibrium. Those who are tempted to over-emphasize the monetary factors, profess scepticism regarding the undue growth of production in the case of a great number of commodities. But one is on firmer ground when one regards the constant improvement of technique and increase of area cropped on the agricultural side and the steady growth of mass production and better methods on the manufacturing side. We have been having, in fact, a series of industrial and agricultural revolutions all comprised in course of a single generation, and in the race between population and production the latter has been winning decidedly, thanks to the continuous progress of science, invention and methods of transportation."⁵ The Report of the Economic Committee of the League of Nations on the agricultural depression at present is a classical document and points out the effects of technical improvements, of new scientific methods and of bringing new areas of land under cultivation upon the production of agricultural commodities. In certain directions this increase has been tremendous. The Report says that "From certain stocks a really excessive harvest has been obtained which has become a danger for the wine growing industry." Further, "There can be no doubt that the seriousness of the depression is principally due to the over-production of cereals, which are most suitably grown in overseas countries where large fertile tracts of land can be extensively tilled by mechanical methods, and where it is difficult to rationalize production by substituting other crops for cereals." (*Report on the Agricultural crisis of the Economic Committee of the League of Nations*, pp. 79, 83 and 292.)

Geographical redistribution of industries which has taken place since the war has been emphasized by certain experts⁶ as the main cause of the crisis. This has been a contributory

⁵ Sir J. C. Coyajee, *The World Economic Depression: A Plea for Co-operation*, p. 9.

⁶ *The Report of the Director of the International Labour Conference*, Geneva, 1932, p. 31.

cause of over-production. Before 1914 also industry was no longer the monopoly of Western European countries and America. India, Japan and Latin America were developing their industries with the help of modern equipment and skilled labour and during the war this development was stimulated because the belligerent countries could not supply their customers overseas as their attention was turned to the production of war materials. Thus when the new enterprises were established, it was natural to foster their growth in these countries to supply their own domestic requirements and to compete with the old industrialized countries.⁷ Russia has been industrialized to a great extent and her products are becoming a menace to the old countries in the world markets. Though the country is not yet a great exporter of manufactured goods yet it is undergoing a rapid industrial transformation which in course of time will have considerable repercussions on the rest of the world. The second Five-Year Plan which is being elaborated to cover the period from 1933 to 1937 will enable the country to throw on the world market large quantities of raw materials and cheap manufactured goods.⁸

⁷ The following figures show the annual rate of industrial expansion in different parts of the world between 1913 and 1929:—

| Zone I :—Industrial Europe (Austria, Belgium, Czechoslovakia, Denmark, France, Germany, Great Britain, Luxemburg, Norway, Netherlands, Saar, Sweden and Switzerland) | Per cent. +1 |
|--|--------------|
| Zone II :—Agricultural Europe (Bulgaria, Estonia, Finland, Greece, Hungary, Italy, Latvia, Poland, Portugal, Roumania, Spain and Yugoslavia) | +2.2 |
| Zone III :—Highly Capitalized Extra-European (United States and Japan) | +3.5 |
| Zone IV :—Moderately or Newly Capitalized Extra-European (Argentina, Australia, Brazil, Canada, Chile, India, Mexico, New Zealand, Peru and South Africa) | +3.6 |
| Zone V :—U.S.S.R. (to 1931) | +6.3 |

It cannot be denied that this dissemination of industrial activity, which during the last century was for the most part centralized in Western Europe, is bound to provoke considerable disturbance of the old economic balance and to require considerable readjustments. With the development of automatic and semi-automatic machinery, it is certain that the range of industrial production will rapidly spread even in countries with no previous industrial experience. There are few countries which could not now manufacture their own requirements in textiles, cement, soap and many other articles of common consumption. With the growth of economic nationalism, it is becoming a matter of pride in most countries to produce home-made goods, whether they can be produced on a strictly economic footing or not. Moreover, a further impulse has been given to the tendency by the depression, which has forced so many Governments drastically to curtail imports from abroad in order to preserve their balance of payments. (See the *Report of the Director of the International Labour Conference*, 17th Session, Geneva, p. 32.)

⁸ Paul Einzig, *The World Economic Crisis, 1929-1931*, Chapter XX, pp. 105-109.

The effects of maladjustment in production can be understood by considering the changes on the demand side. There are factors which have produced instability of demand by changing the distribution of income between various classes of people. This has been the case during the war and the post-war period owing to inflation and deflation policy, rise of wages and the growth of a new property-owning class. Further, there has been the growth of *per capita* income in several countries. These changes dislocate the usual standards of consumption and make the demand unstable. If wealth passes on into the hands of people who were below the line of subsistence, they have yet to develop their standard of consumption in order to suit their new resources or as Sir J. C. Coyajee whose valuable work has already been referred to says, "They have yet to be educated into the proper use of their new resources." Choice is open to the consumer to spend that portion of his income which is beyond the ordinary elementary needs. There are other conditions which directly reduce and lower consumption. Such is the effect of the fall in income and of the lag between wholesale and retail prices. Protective tariffs raise the prices of goods and lower the purchasing power of consumers. The reduction of foreign investments by the creditor countries has reduced the purchasing power of people in debtor countries. Reparations payments and a heavy burden of taxation also reduce demand and till recently the falling price of silver was reducing the purchasing power of people in several countries. All these factors operate on the demand side and lower the purchasing power of the people, thus creating maladjustment between production and demand.

The maldistribution of gold is another cause of the present depression. It is not the scarcity of the gold supply so much as its maldistribution which has been a contributory cause of the present depression. The Final Report of the Gold Delegation of the Financial Committee of the League of Nations bears eloquent testimony to this statement. The following table shows the distribution of the world's monetary gold stocks:—

DISTRIBUTION OF THE WORLD'S MONETARY GOLD STOCKS
(*In millions of dollars*)

| | 1-1-29 | 30-6-31 | Change | Percentage |
|---|--------|---------|--------|------------|
| France .. | 1,271 | 2,211 | +940 | +74 |
| United States .. | 4,141 | 4,956 | +815 | +19½ |
| Rest of world (excluding U.S.S.R.) about .. | 5,550 | 4,650 | -900 | -16 |
| TOTAL .. | 10,962 | 11,817 | +855 | 8 |

"The world's total monetary gold stocks (excluding those of U.S.S.R.) increased in the period covered by the above table by 8 per cent. The holdings of France increased by no less than 74 per cent., and those of the United States by 19½ per cent. or, if the stocks of those two countries are combined, their increase is 32½ per cent. The stocks of the rest of the world, on the other hand, decreased by 16 per cent. These stocks should normally have increased by roughly 3 per cent. per annum, so that the real deficiency at the end of the period considered amounted to about 23 per cent. The loss of free gold reserves in excess of legal minimum requirements was, of course, relatively much greater. Thus the countries concerned found it impossible to maintain the level of prices obtaining at the end of 1928. In order to defend their gold reserves, their Central Banks had to apply the normal measures of deflation. The process of deflation thus set in motion gathered momentum when it became apparent that contraction of credit and falling prices in the gold-using countries failed to re-attract gold to their depleted monetary reserves, but that, on the contrary, the flow of gold to France and the United States continued unabated. The result was a further pressure upon commodity prices in the gold-using countries, increased competition in world markets, and in consequence, a world-wide fall in prices."⁹

It is thus clear that a major portion of the gold resources of the world which are larger than before the war is hoarded in America and France and the rest of the world does not possess an adequate supply to meet the necessary demands.¹⁰ Thus it is not the shortage of gold but its maldistribution which is mainly responsible for the depression. "Needless to say that this maldistribution of gold is a far more formidable factor in the depression than the shortage of gold. This shortage is quantitatively not very great, at least if the world is content not to raise its price level by a drastic upward movement." (Sir J. C. Coyajee, *The World Economic Depression: A Plea for Co-operation*, page 19.)

The problem of the maldistribution of gold is very closely related to the unwillingness of the creditor countries to lend capital to debtor countries. The economic situation would not be balanced if the maldistribution of gold were not compensated by adequate lending on the part of those countries that are capable of lending. By the year 1928 the creditor countries were becoming very slack in lending capital and America which up

⁹ See the *Final Report of the Gold Delegation of the Financial Committee of the League of Nations*, p. 65.

¹⁰ Paul Einzig, *The World Economic Crisis, 1929-1931*, pp. 26, 27 and 49-57.

to 1928 had been lending heavy amounts reduced loans as will be shown by the following table¹¹ :—

| | | U.S. Capital Issues for the Account of European Countries | Canada | Other Foreign Countries (\$ 000,000's) |
|--------|-------------|--|--------|---|
| 1927 : | First half | .. | 244 | 154 |
| | Second half | .. | 333 | 78 |
| 1928 : | First half | .. | 449 | 115 |
| | Second half | .. | 148 | 70 |
| 1929 : | First half | .. | 101 | 167 |
| | Second half | .. | 59 | 124 |
| | | | | 135 |

The reasons are: Firstly, America did not have favourable balance on commercial account excepting the amounts due to it on allied debt and other foreign investment accounts, and, therefore, it could not lend heavily. Secondly, the instability of the currencies of a number of countries led to wide speculative movements of short-term capital and 'the misuse of short-term credit made by debtor countries justified the denial of further credits to them.' Further, violent price changes have discouraged direct investments in productive enterprises of debtor countries. The service of the debt has increased the actual burden of the debt upon the debtor countries at times of falling prices of their goods. In order to remove this defect a bold policy of international monetary co-operation which unfortunately has not so far been forthcoming, is necessary. A bold policy of foreign loans is exceedingly necessary at the present time.

Questions of banking policy and of control of investments and of prices on the part of Central Banks are closely related to the present depression. Professor Keynes¹² and other writers have urged that banks have restricted credit and interest rates have consequently remained at higher levels than ought to have been the case. It should be said that this action of the banks was to a certain extent due to the shortage and maldistribution of gold and this latter situation in itself was caused by changes in balance of payments and to contraction of capital movements. The result was a fall in prices and curtailment of production. The necessity of distress borrowers including governments and businessmen kept up the rates of interest. There could have really been a more liberal policy followed by central banks in the matter of credit which could have mitigated the severity of the crisis. Banking opinion does not agree on the point with the view mentioned above.

¹¹ Report of the Gold Delegation of the Financial Committee of the League of Nations, p. 19.

¹² Keynes, *Treatise on Money*, Vol. II, pp. 377-380.

According to this view banks can control the quantity of money and rates of interest for loans, but they cannot control the rate at which money circulates and the use to which it is put. Banks cannot put money into circulation irrespective of the factor of psychology. Additional money might be employed in speculation and not in genuine businesses or it may be immobilized by the dislocation of markets and a large part of it may be left idle by the owners.

It is thus no use to criticize the banks for the policy they have pursued. What is necessary is that the gold standard or any other standard of the future should be more systematically managed and the central banks can take a leading part in the scheme of management. "It is not in any sense the fault of the banks that they could not foresee the necessity of rationalizing the whole scheme of world economy and of submitting it to a system of central planning in which their credit policy had pivotal importance. But in future, they must keep this point in mind and try to evolve a scheme of credit statesmanship to correspond to the new conditions—a statesmanship of which the main plank is a wise co-operation between central banks."

The inelasticity of the price system is also responsible for the present crisis. 'The abnormal behaviour of the price system during the post-war period' has acted adversely on economic conditions and has brought about an acute depression. There has been the maladjustment of wholesale and retail prices. Consumers have become reluctant to purchase goods in the expectation of falling retail prices and wage policy has been complicated. The various costs of production, the costs of transport, labour and capital which are employed in production cannot easily be adjusted to prices. There has also been a maladjustment of prices of agricultural and manufactured goods. The prices of agricultural products have fallen to a greater extent than those of the manufactured goods. The weight of tariffs has been greater in the case of manufactured goods than in the case of agricultural products. Comparative inelasticity of agricultural supply and lack of big business establishments have been other causes responsible for a greater fall in agricultural prices. Monopolistic tendencies are also responsible for the lack of elasticity of the level and system of prices. "All commodities under strict control account for a special class of difficulties both when they fail to adopt themselves and when the control breaks down, as happened with some of the most important of them." (*American Review*, March 1931, p. 181, quoted by Sir J. C. Coyajee.)

The reduced plasticity of wage rates, i.e., the lack of adjustment of wages to falling prices, is also stressed as a cause of

the present acute depression. Real wages should alter in response to changes in demand for commodities and if wages can be reduced with falling prices, depression and unemployment can be reduced. In Western countries, the political power of labour and the strength of labour organizations have prevented a fall in wages which ought to have been brought about to suit falling prices. According to Prof. Pigou a certain amount of extra unemployment must be ascribed to the fact that real wages have been maintained above the equilibrium level.

This may be true of a number of countries, but it cannot apply to all countries. In some countries wages can be increased advantageously which will increase the efficiency of labour and enlarge the demand for goods produced by labour. The lack of elasticity of wage rates is thus only a local factor of the depression. One is inclined to agree with Sir J. C. Coyajee when he writes, "While, therefore, it is undoubtedly dangerous to pronounce any dictum on the topic which can apply to all countries individually, yet taking the world as a whole, one can accept the summing up of the problem by the German Savant....to the effect that 'the depression has not been brought about by the rate of wages, but having been brought about by other factors is much intensified by this factor'.

.... If we undertook a direct reduction of wages as an immediate remedy in a period of deep depression, the result might only be to reduce demand for commodities and thus to intensify the depression. The better course is to register as it were for all future use the need for plasticity of wage rates which present depression has so well taught. It is not in the very midst of a great crisis that we can expect the normal sequence of effects to follow and hope that reduction of wages must needs bring about a reduction of prices and its usual corollary—an increase of demand and rise of profits." (*The World Economic Depression*, pp. 27, 28.)

The tariff policy of the post-war period leading to high protectionism has complicated the situation and has created poverty in the midst of plenty. Goods are produced, but consumers cannot purchase them because their prices become prohibitive till they reach consumers in foreign countries. This policy has shown the worst evils of narrow economic nationalism. During the war, a large number of industries grew up in various countries and they are being supported by high tariff walls in the post-war period. On the top of this there has been a system of import and export restrictions which has impeded the free movement of goods from country to country. Even England the home of free trade has become definitely a protectionist country and the conclusion of the Ottawa Agreements as a result of the famous Ottawa Conference has

jeopardised the chances of the removal of tariff barriers. The world is being divided as it were into economic war camps.

The Warsaw Resolution of 1931 'in which the main innovation consisted of preferential treatment which the agricultural countries of Western Europe proposed to receive from the manufacturing countries that would import their agricultural products'; the proposals brought forward in the League Assembly 'to go back upon the recommendations of the World Economic Conference and to formally impart to the Most Favoured Nation Clause a conditional and limited interpretation and meaning'; the adoption of protection by the leading free trade countries and the signing of the Ottawa Agreements have been the main stages towards the intensification of tariff barriers in the post-war period. The creditor countries have levied high tariffs upon the import of goods from the debtor countries lest the industries of the former should be crippled by the competition of the latter countries. In this connection the relevant remarks of the Report of the Gold Delegation of the Financial Committee of the League of Nations are worth quoting. They are: "The trade cycle is to-day an international phenomenon. Countries cannot hope to escape its effects by self-isolation. They can only hope collectively to lessen them. To this end they must permit an adequate freedom in the flow, not of credit alone, but of goods. In our opinion it is imperative that the restrictive commercial policies adopted by Governments to-day should be radically changed. Adherence to an international monetary standard at once implies and necessitates adherence to an international economic system. To impose artificial restrictions on the movement of goods is the negation of such a system." (Paragraph 227 of the Report.)

The problem of reparations has aggravated the acuteness of the depression. Germany was oversaddled with a huge indemnity by the Peace Treaty in 1919 and the Dawes and Owen Plans reduced the amount of indemnity to a great extent, but still Germany is unable to pay. The possibility of paying reparations is out of the question and even Mr. Lloyd George, the author of the Treaty, is prepared to admit the injustice of reparation payments. Eminent economists have been busy in indicating the possibilities of their payment. The debtor countries could pay them in goods, but it would retard the industrial development of the creditor countries and this idea alarmed the experts themselves. The unpaid reparations have worsened the economic situation in every way. They have upset balances of trade and have brought about the mal-distribution of gold. Production has been misguided and deflected and 'increased productivity has been made the instrument of securing an artificial excess of exports as a means

of effecting vast payments.' They have been responsible for the maladjustment of production to demand. They have increased the burden of taxation and have consequently reduced the purchasing power of people and crippled commerce and industry. Competition has been intensified, international jealousy promoted and thus they 'have acted as brakes on international lending'.

The importance of the psychological factor as a cause of depression should not be underrated. In a period of falling prices, businessmen become pessimistic and are reluctant to undertake business because of the further possibility of fall in prices. Consumers put off purchases in the hope of further fall in prices. These factors act very powerfully when the fall in prices is very acute and this fact has to a great extent been responsible for the present depression.

The trade cycle theory has also been advanced as a cause of the present depression which is in no way regarded as exceptional or extraordinary. Before the war there was a crisis every seven or eight years and this state of affairs has not changed. The war disorganized the economic system but it did not change the fundamental tendencies that have brought about crises since the beginning of the modern economic system. Except for the war probably the crisis would have recurred near about 1917 and it was postponed till 1921 as a result of exceptional circumstances. In less than ten years the business cycle completed its course once more and after a small period of prosperity, the crisis broke out in 1929.¹³

In fine, it may be said that unregulated and constant extension of production and productive capacity, monetary and currency disturbances and the maldistribution of gold, central banking policy in the post-war period, high tariff walls, anti-social labour policy in some countries, the business cycle theory and reparations and war debts bringing in their train high taxation, increased production and falling demand have been responsible for the present depression.

REMEDIES

Sir J. C. Coyajee in his excellent and learned work that has already been referred to above has made a powerful appeal for international co-operation to deal with the crisis. Co-operation between governments, central banks, producers and consumers is emphasized by him as a solution of the problem. America set up the pace as a creditor country in rendering help by its moratorium offer, but it was not accepted in the proper spirit and was ruined by political bitterness. 'The world was waiting

¹³ Paul Einzig, *The World Economic Crisis, 1929-1931*, pp. 24, 25, 29-34.

for the emergence of some definite and new outside factor. Unfortunately, when such a factor did make its appearance, political bitterness at once marred the prospect.' Banking co-operation has so far been tried on a limited scale and the Bank for International Settlements has yet to go a long way before it works up to its programme. Co-operation should be the economic policy of the future and in this connection reference may be made to the remarks of Mr. H. A. F. Lindsay which are : ' I suggest that science has out-stripped economics—that science has been quicker to respond to the new spirit which is now abroad, a spirit which is best described as a change over from the ideal of competition to the ideal of co-operation, from the ideal of efficiency attained under pressure of environment and other outside forces to the ideal of efficiency to be attained by mankind working consciously, constructively and in co-operation towards a common goal. We cannot eliminate competition altogether, and we probably would not do so if we could. But I suggest that as a constructive force it is too instinctive, too haphazard, and too unreasoning to be allowed to occupy the whole field. Its future position will be definitely subordinated to a new force more constructive, more controlled, and therefore itself better qualified to exercise deliberate and conscious control.'¹⁴

The treatment of the remedial measures may now be taken up with reference to the importance of the causes of the depression. Reparation payments and war debts have got to be wiped off. Germany has made unparalleled efforts to set her financial and industrial conditions in order and has effected rationalization in every line. Yet her debt seems to be growing and not diminishing and the rest of the world in place of taking from Germany is lending her more and more. Germany has been making payments out of the proceeds of the loans and as a matter of fact she cannot pay the reparations with the high tariffs impeding her exports so successfully. The Dawes Plan adopted the 'capacity to pay' theory and provided help to Germany in the shape of loans and the Young Plan provided for temporary moratoria and conditional reparations. Still she cannot pay. The Basle Committee of Enquiry further recommended a reduction in the Reparations payments by Germany to promote her financial stability. According to the Report of the Gold Delegation referred to above the final solution of the Reparations problem at an early date is 'an essential factor for a return of the lost confidence in the sphere of international finance. The gradual and cautious resumption of international credit and capital movements, which

¹⁴ *Journal of the Society of Chemical Industry*, February 5, 1932, p. 122, quoted by Sir J. C. Coyajee in his work entitled *The World Economic Depression*.

seems to us of vital importance for the working of the gold standard cannot be expected before this problem is solved.' (Page 24, paragraph 81 of the Report.) In the Note of Dissent the minority write, "Some reasonable settlement of the reparations and war debts questions must be effected, and this settlement must be of such a character as to make it quite clear how (a) reparations and war debts can be paid and the payments received, and (b) how this can be accomplished without serious interference with the working of the gold standard." (Page 70 of the Report.)

Of course the problem of reparations cannot be settled without the problem of war debts and to abolish the former without abolishing the latter would create injustice between debtor and creditor nations. The agreements and conclusions of the Lausanne Conference on the point were made dependent upon the attitude of America. She refused to become a party and the question was to be settled at the World Economic Conference which met in July 1933; but unfortunately it was terminated without settling any question whatever.¹⁵

The maldistribution of gold must be remedied in order to promote international lending and free flow of capital which can bring about a rise in prices. The gold resources of the world should be better utilized and America and France should give a lead in the matter. By going off the gold standard, the former country has complicated problems to a greater extent. The Gold Delegation did well to emphasize the importance of the lending states in maintaining an even flow of capital. This question cannot be settled without settling the question of the restoration of currency conditions. The stiff attitude of America at the World Economic Conference on this question was a great blow to that body owing to which it had to disperse without doing anything.

In case the problem of the maldistribution of gold is not solved in this way, it is difficult to see whether the world can wait indefinitely till the balance of trade goes against France and America and they have to send gold out. France has developed her manufacturing industries greatly at the expense

¹⁵ The Prime Minister of England, Mr. Ramsay Macdonald, in his Presidential Address to the World Economic Conference remarked as follows in connection with reparations and war debts:—

"Behind the subjects I have just mentioned is another in the front rank of importance..... I refer to the question of war debts, which must be dealt with before every obstacle to general recovery has been removed, and it must be taken up without delay by the nations concerned. Lausanne has to be completed, and this vexed question settled once and for all in the light of present world conditions." See page 138 of the *Monthly Summary of the League of Nations* for June, 1933, already referred to above.

of Germany and America. The adverse balance of trade may not be consummated for a very long time and thus the automatic remedy for removing the maldistribution of gold will be very uncertain and bound to take an unconscionably long time. Some experts as Sir A. Salter have proposed the formation of a sterling block consisting of those countries which adhere to the sterling standard and as the number of countries going off the gold standard increases, the possibility of the formation of the sterling block increases. This will, of course, mean a sacrifice of the stability of exchange; but, at the same time, it may lead to the stability of internal prices and thus the countries comprising the sterling block will become masters of their own economic policies.

Several advantages for the plan have been claimed. Firstly, a fall in price level could be prevented by the skilful adoption of a suitable price level and it might also stimulate imports into the gold standard countries forcing them to part with their gold.¹⁶ Secondly, this co-operation in currency matters might be extended in scope to include production, marketing and tariffs. The adoption of the sterling standard by a large number of countries will give a sort of training in the art of currency management.

The monetary system of the world should be set in order and a policy of banking co-operation has to be evolved in any case. There should be a central international control of gold supplies and credit as emphasized by experts like Mr. Keynes and Sir Josiah Stamp. The various Reports of the Gold Delegation of the Financial Committee of the League of Nations indicate the lines along which improvements are possible. The most important of their recommendations are: Firstly, there should be a reduction of the reserve ratios by the central banks. They have distinguished between 'minimum gold reserve' which is necessary to preserve confidence in the notes and the 'surplus reserve' which is required to meet international obligations. As gold is not in circulation, the reserve ratio can be considerably reduced. There is another recommendation 'to the effect that only a gold influx or efflux caused by temporary disequilibria might be advisedly neutralized by central

¹⁶ Now that America has depreciated her currency, imports into the country will not increase and the power of the U.S.A. to compete in foreign markets will immensely increase. This will lead to a race in currency depreciation and nobody knows where it may end. Further, it is not certain whether the countries of the sterling block will really be masters of their own economic conditions. This may not be the case with India where people feel that the currency policy is not being followed to suit Indian interests. If this belief could be removed, the formation of the sterling block may be really advantageous.

banking policy.' There is another recommendation to the effect that gold outflow and inflow should be generally permitted to produce their effects. These two recommendations are apparently contradictory, but it is really not so. The idea is that individual central banks should not follow a policy that may interfere with the general distribution of gold, but at the same time they are free to follow their policy of pre-war days to allow the inflow or outflow of gold on the ordinary scale.

Their other recommendations are intended to remove the defects of the Gold Exchange Standard that have recently crept into its working. The development of the bill market and resort to open market operations have been suggested. They are a new instrument of credit policy and their working has not yet been fully examined. The Delegation have also recommended that the even flow of capital should be maintained. The utmost economy in the use of gold by avoiding gold currency in circulation and also by adopting a suitable mechanism for varying gold reserve requirements has been advised. Price stabilization can be undertaken by central banks if they co-operate to limit the demand on gold and regulate prices. The management of the improved monetary standard must be on international lines, and co-operation on the monetary side is as necessary as in other phases of wealth production. There was a sharp cleavage among the monetary sub-committee of the World Economic Conference ; and the gold standard countries and non-gold standard countries differed widely on the point.

Tariff barriers must be considerably lowered so as to allow the free flow of goods from the producers to the final consumers. The World Economic Conference of 1927 had emphasized the necessity of lowering the tariff barriers and the same point was emphasized at the World Economic Conference of June, 1933. This co-operation can be achieved along different lines. Firstly, maximum tariff rates may be fixed and gradually they may be lowered by international action. Secondly, there is the method of regional preferences. Both these measures were suggested at the World Economic Conference of 1927 ; but 'the great ideal of general co-operation for a comprehensive reduction of tariffs was abandoned while only the plan of regional preferences received a fair measure of support.' This latter policy, if carried out within the framework of the League, would destroy its economic solidarity. Such regional agreements should only be regarded as stepping stones to a general reduction of high tariff walls and it is then only that they can be said to be useful remedial agencies.

Rationalization, *i.e.*, the improvement of production through various measures of reduction in costs has been partly

responsible for the depression and unemployment. Rationalization means the methods of technique and organization planned to secure the minimum waste of labour and material. It includes the scientific organization of labour, standardization of materials and products and improvements in transport and marketing. If rationalization is adopted to lower down costs, care must be taken to avoid certain dangers of the movement. It should be adopted to suit local conditions so that it may not lead to the over-development of industrial equipment without a corresponding improvement in effective demand. It is bound to cause temporary unemployment; but this problem is parallel to the immediate effects of the introduction of new machinery upon employment. Thus rationalization has to be so controlled as not to reduce the aggregate volume of employment.

The agricultural crisis also has got to be remedied. Its remedy should be capable of world-wide application and it should aim at improving the standard of living of the agriculturists so that demand may be stimulated. The costs of production in agriculture should be reduced. The burden of agricultural debt which has aggravated the present crisis must be lightened. There should be better organization of markets and sales of agricultural products should be regulated so as to reduce the weight of the charges of middlemen. In other words, 'agriculture has to organize itself in order to put itself on the same footing as manufactures in the matter of adjustability to changing conditions.' Agriculture should be organized on a co-operative basis to a much larger extent than has been the case hitherto.

THE DEPRESSION IN INDIA

India also has been hit very hard by the "Economic Blizzard" and its main features have also been reflected here. There has been a rise in production mainly on the industrial and mineral side though the production in agriculture also has exceeded demand. The prices of export staples have also considerably fallen. The fall in prices between the years 1929 and 1931 has been 50 per cent. for raw jute, 49 per cent. for oil seeds, 47 per cent. for wheat and 35 per cent. for rice.¹⁷ This is due to the growth of output and business on the one hand and the decrease in the rate of expansion of currency and a great fall in the velocity of its circulation on the other. Savings and investments have also fallen, but a large amount of capital has gone abroad. The balance of trade has also altered and the total favourable visible balance of trade fell from

¹⁷ *Review of the Trade of India, 1930-31, p. 7.*

53 crores in 1928-29 and 1929-30 to 38 crores in 1930-31. (Statement II, Report of the Controller of Currency for 1930-31.)

The disturbed political conditions of the country, the currency policy of the Government, high taxation, increasing burden of military and civil expenditure in a period of falling prices and reduced demand, lack of staying power of mill industries and intensification of foreign competition have all combined to intensify the crisis. Unemployment has increased to an unprecedented level. A crop of strikes during the last few years has reduced the purchasing power of labour and has aggravated the crisis. The agricultural industry has suffered because our exports have to face the keen competition in foreign markets and the burden of rent and land revenue is very large. Broad, general world causes also operate in the case of India as in the case of all other countries.

The remedy lies in extending the co-operative movement to all phases of agricultural industry and in lightening the burden of taxation, rent and land revenue. Banking and currency policy should be such as to promote the saving and investment of capital in industries. India can make a very solid contribution to the economic stability of the world if conditions here improve. In the absence of international co-operation, a policy of systematically planned economic development for the country is inevitable and the same should be put into effect with the co-operation of the Government and the people without undue delay.

It may be emphasized that it is an all-round international co-operation that can tackle the problem of the "Economic Blizzard" that has overtaken the world at present. No country in isolation can improve matters. Local conditions can be and ought to be improved individually, but for world-wide causes international co-operation is necessary. The League of Nations is the proper agency to move in the matter, but this can be done only when the representatives of 'big powers' meet in a spirit of give and take and it is really a pity that this spirit was not displayed at the last World Economic Conference which was convened with high hopes, but ended in despair. It is not eloquent speeches, but bold and concerted action that alone can cope with the problem.

CHAPTER XXV

Credit System

MODERN industrial society has often been called a credit society. This means that credit is the most significant factor in the organization of production, industry and commerce at the present day. Credit has been called as the life-blood of commerce and as "the heart and core of the modern business structure." These common statements emphasize the vast importance of the credit system under modern industrial organization.

It is very necessary to understand the real nature and significance of credit. The fundamental notion underlying credit is confidence or trust ; but this characteristic has obviously a limitation inasmuch as the purchaser must repose some confidence in the seller even when the dealings between the two are strictly on a cash basis. Thus a second principal characteristic involves the idea of deferred payment. Time is the essence of credit, and the use of a commodity or money is to be given now ; whereas the reciprocal service or commodity is to be given after a specified period of time. The person who grants credit has confidence in the honesty and financial standing of another person inasmuch as the latter can be entrusted with something of value.

This confidence in part is based upon the borrower's property and in part upon his personal characteristics. The character of the borrower and the character of his business are the customary matters to be investigated by the person granting credit. There is a close relationship between these two factors ; because "a man of excellent business ability..... would have his business properly organized, and on the other hand, if it were found that a business was poorly equipped and managed, it would be certain that the man's business experience or business capacity was strictly limited. An investigation of these two kinds, however, usually serves to furnish a more adequate basis for a sound judgment of the risks involved."¹

Credit has acquired a specific importance in modern society, where production is in anticipation of demand and there is a highly complex system of exchange. In such circumstances, a businessman is a debtor as well as a creditor and a large amount of his dealings are on a credit basis. The borrower

¹ Marshall, *Industrial Society*, p. 328.

obtains credit only so long as he proves his ability to pay more for the use of capital than its owners will gain by using it themselves. Credit must be capable of being generalized if it is to prove useful. This is done in two ways : " (1) by expressing credits in terms of money, which is generic and (2) by such an organization of credit instruments and credit institutions that the owner of personal industrial capacity may readily exchange his individual credit, a purely specific thing, for wider credits."² This is done by banks which in modern times have universalized individual credit by the process of bill-discounting business.

FORMS OF CREDIT

Credit has been divided into many classes, i.e., Public Credit ; Capital Credit ; Mercantile Credit ; Individual or Personal Credit and Banking Credit.

The term *Public Credit* refers to the borrowing operations of governments by means of interest-bearing securities. The government makes a promise to repay the principal on certain terms and conditions, and interest is to be paid from year to year at a certain rate. Thus it is in a position to finance its various needs. The purchaser of the interest-bearing security accepts the government's promise to repay the money and has full confidence in that promise. The government may also issue paper money to finance its needs.

Capital or Industrial Credit means the credit used by corporations in obtaining the necessary finance for their business operations. The corporation promises to repay the principal on certain terms and conditions with interest. The creditor lends money to the corporation ; because he regards the credit of the corporation as good.

Mercantile Credit is made use of by producers, wholesalers, retailers, etc., in connection with the manufacture and sale of commodities. A manufacturer who buys raw materials on credit agrees to repay the price after a certain period of time. He has thus been trusted by the producer. He may also obtain credit from a bank for a short period of time. In this case he has used his credit with the bank instead of with the seller of the raw materials ; but the nature of the operations is the same in both cases. A wholesaler or a retailer may likewise do the same thing in connection with the goods that he purchases for his business operations.

Mercantile Credit is to be distinguished from *Industrial Credit* inasmuch as the former runs for a short period and the latter for a long period of time. Further, *Mercantile Credit* is

² *Ibid.*, p. 329.

represented by bills of exchange, promissory notes, etc., while Industrial Credit by bonds or stock certificates.

Personal or Individual Credit is connected with individuals rather than with public or private corporations. The individual can procure consumption goods without paying cash for them. There is a difference between personal credit and other credit in the matter of the character of the security and in the matter of the use made of the things borrowed. The basis of security is an indirect one, consisting not of actual property, but of a recognized earning power from personal or professional services. The things borrowed are generally used for immediate consumption and not for production. Such credit is also called "*Consumption Credit*" for this reason and also "*Retail Credit*" because it is used in retail transactions.

Banking Credit refers to the funds obtained by a bank from its own capital and borrowed from individual depositors. A bank can extend its credit by its reputation, honesty and business integrity. The simplest use of its credit lies in the entrusting of funds with a bank by its depositors ; but there is a more important way in which banks make use of their credit. A bank borrows when it creates obligations, either in the form of bank notes or deposit accounts against which cheques can be drawn. The demand obligations of a commercial bank usually amount to several times the amount of their actual cash resources.

Looked at from another point of view, credit may be classified as *Commercial* and *Investment Credit*. This classification is of greater significance from the point of view of economic analysis and also for a clear understanding of the principles underlying banking operations.

Investment Credit is that which is used for financing and developing business enterprises such as factories, farms, mines, etc. The funds borrowed are invested in block capital and the repayment is to be made after a long period of time. The lender regards this disposal of his funds as permanent ; and hence the term *investment* is used for these operations.

Commercial Credit, on the other hand, is used in financing the manufacture and marketing of goods. It is another name for *Mercantile Credit* explained above. The borrower uses the funds for a short period only. A merchant, for instance, purchases goods worth rupees one lakh on two months' credit. He intends to repay this sum of money after two months, because in the meantime he will be in possession of funds by selling his goods at a profit. The borrower for investment purposes, on the other hand, invests money in a factory, and it may take many years before the accumulated profits of the factory will

permit the repayment of the principal of the loan. The latter is essentially a long-term operation ; while the former may be carried to completion within a few months.

Credit instruments consist of bills of exchange, cheques, bank notes, bank drafts, debenture bonds and government securities. It is largely through these instruments that credit operations are carried on. In a limited number of cases book debts and book entries serve as an evidence of loans. The volume of business that can be done by credit paper depends on several factors. *Firstly*, it depends upon the banking facilities of a country. If the banking system in a country is widely developed and if the banks are willing to deal in transactions small enough to be within the reach of a large number of people, many more transactions will be settled through banks than would be the case otherwise. *Secondly*, the density of population is another factor in the development and the ease of credit exchanges. A larger volume of business is done by credit instruments like cheques in a commercial centre than in an agricultural community. *Thirdly*, the *education and intelligence* of the bulk of the people is another important factor determining the use of commercial credit instruments. Men do not use banks unless they have confidence in them, and they have come to be regarded as part-and-parcel of the commercial life of a community.

FUNCTIONS OF CREDIT

The chief functions and merits of credit are :—*Firstly*, it economises metallic currency, and thus substitutes a cheap medium of exchange for a more expensive one. *Secondly*, it enables payment to be deferred until it is convenient for the borrower to do so. Thus the borrower is in a position to carry on his business smoothly and without great difficulty. *Thirdly*, it also permits the centralization of a great multitude of small amounts in bank reserves with the help of which industries, commerce and trade can be financed. It thus increases the mobility of capital and stimulates production as a whole. *Fourthly*, the fluctuations in prices can be minimised by a careful regulation of the volume of credit and trade is thus stabilized and stimulated. A regulated credit policy ensures the smooth carrying on of business by avoiding booms and depressions. *Finally*, the modern mechanism of credit is a very powerful instrument for promoting business progress and for facilitating inventions and improvements in industry.

DRAWBACKS OF CREDIT

The settlement of a very large proportion of exchanges by means of credit paper introduces a delicacy of character into the business life of a community by which the trade mechanism

may be easily upset. If the part played by the credit mechanism in the financial sphere is very great as compared with the part played by the volume of money, the possibility of the breakdown of confidence is considerably enhanced. This factor might put a very great strain upon the economic life of a nation. Thus there should be some check upon an undue expansion of credit by the credit institutions of the country concerned.

The greatest danger of credit lies in its liability to excess. The fact that more notes may be issued by banks than are necessary for the business needs of a country is a real danger of the credit system. The confidence infused into the business community in a period of general prosperity in trade and industry very often leads to over-production, over-investment and speculation of the worst type. An enormous superstructure of credit may be built up on a small reserve with the result that an untoward event would shake public confidence very rudely, bringing about a violent contraction of currency in its train.

The modern credit system is also responsible for disguising the financial weakness of a business community by enabling the unscrupulous businessman to continue in business with the help of borrowed money. His eventual failure would bring ruin not only to himself but to a whole host of other persons, whose capital was deposited with him for use.

The credit organization is also responsible to a great extent for putting the control of capital under the charge of big monopolistic combinations of producers. The results need not, however, be necessarily harmful; but as some writers think, they may not be so beneficial as they might be when capital is left in the hands of a large number of producers. Very frequently, the control of a large amount of capital by monopolistic organizations leads to the exploitation of labour, to unfair competition, and to an increase in prices. Further, in periods of the expansion of trade, waste is encouraged by governments and businessmen also, when credit is obtained very easily.

A proper system of control over the credit policy of a country by some responsible authority is thus very necessary, if the evils thereof are to be avoided and if the maximum of advantage is to be taken of the credit mechanism. The dangers of the credit system become accentuated in those advanced business communities which lack a properly organized money and capital market and a strong central banking institution.

CAPITAL AND CREDIT

There has been a great deal of controversy with regard to the distinction between capital, in the sense of production

capital, and credit. From the point of view of an individual merchant, his good credit is one of the principal requisites for his business. A trader, a businessman or a manufacturer can increase his business with the help of his credit. It cannot, however, directly create wealth, because it cannot increase the actual means of production which are potentially available to a nation. Credit enables the transference of wealth from the savers to the users and thus facilitates production. It helps in transforming idle capital into capital that can be used for actual production. In this connection, the following passage deserves quotation, because it brings out clearly the distinction between capital and credit so sharply emphasized by Ricardo, Mill and other classical writers :—

"Then, as so often happens in Economics, a simple summation is made of the advantage of individuals, and credit comes to be regarded as part of the national (production) capital just in the same way as a national protectionist policy is fallaciously construed from considering the gains to particular protected industries. It is evident, however, that in its simplest form, so far as production is concerned, credit cannot directly increase the actual means of production which are potentially at the service of a nation, but can only transfer the right to use these means from one member of the community to another."³

In a modern industrial society, exchange is a necessary part of production. Division of labour cannot be carried on without exchange ; and without credit, exchange itself could not be effected sufficiently to facilitate division of labour. Thus under the system of modern industrial society, a well-organized system of credit is essentially one of the most productive forces of industry.

Though this difference between credit and capital must be recognized, it is still open to the economist to point out the different methods by which indirectly credit tends to augment production and also the accumulation of capital. *Firstly*, credit enables capital to pass into the hands of those who can put it to the most advantageous uses ; and *secondly*, it increases the amount of national capital available for production inasmuch as those whose savings are too small to be used alone, are enabled to make an addition to the means of production. It must be remarked that credit is very necessary for the full development of competition, and historically, it is an important characteristic of the progress of society from custom and status to competition and contract. In a large majority of

³ Marshall, *Industrial Society*, p. 326.

contracts, some element of credit is involved ; and therefore indirectly at least, credit increases production inasmuch as it brings into operation those fundamental economic forces which are responsible for the freedom of contract and for the tendency towards unfettered competition.

INFLUENCES DETERMINING THE VOLUME OF CREDIT

The elasticity, that is, the expansion and contraction of credit facilities, depends upon a number of factors of an economic and non-economic character. *Firstly*, the effect of trade and industrial conditions both at home and abroad upon the volume of credit is specially marked. A period of trade prosperity usually promotes the volume of credit ; while bad trade conditions create distrust and fear of the future. Thus there is a falling off in confidence with the consequence that credit is contracted. *Secondly*, the influence of public confidence and general security must be stressed in this connection. The vast superstructure of credit is quickly contracted with a falling off in confidence brought about by a certain event, for example, by the outbreak of war, a severe earthquake, etc. *Thirdly*, the political outlook and foreign affairs are specially important, because they affect public confidence and have important repercussions upon the feeling of security. Credit receives a severe shock at the outbreak of a war, because of the resultant uncertainty which induces bankers to reduce their commitments and to strengthen their reserves. *Fourthly*, speculation also has got an important influence upon the state of credit inasmuch as most of the speculative enterprises suffer first when credit is contracted. The case of the collapse of the American security boom of 1929 may be cited as a suitable illustration on the point. *Finally*, the condition of the currency also affects credit in a material degree. A sound currency system promotes the element of elasticity into the credit mechanism. With a sound and adequate gold backing, the banks can create credit to several times the actual cash reserves. Under a sound currency system, bankers can maintain a low ratio of cash to liabilities, and thus they can extend their credit facilities. A bad and unsound currency system generates a spirit of uncertainty and distrust, which is responsible for credit restriction to a great extent.

CHAPTER XXVI

Stock Exchanges

THE Stock Exchange is a market where stocks and shares are bought and sold. It has been described "as the mart of the world ; as the nerve-centre of the politics and finances of nations ; as the barometer of their prosperity and adversity ;" and in many other ways the importance of the Stock Exchange has been emphasized. The epithet "mart of the world" has been used for it, because the commodities transacted therein represent property in all parts of the world and also because the business of the Stock Exchange is more cosmopolitan than that of any other market except the money market. This institution has been defined as "the nerve-centre of the politics and the finances of nations" because of the specific importance of the wares dealt with in this market and because of their effects upon the financial policy of the leading banks. A glance at the tone of this market suffices to indicate the condition of the finances of a nation and for this reason, it has been called as the barometer of the adversity and prosperity of nations.

The Stock Exchange is the organization of capital for investment and speculation, just as the banks are the organization of capital for loans. All the capitalists and speculators are brought into touch with one another through the medium of the Stock Exchange. It provides a free market for the various kinds of securities and thus promotes investment of capital in business. The knowledge that shares and stocks can be freely marketed in the Stock Exchange enables persons to make investments in them. Most people would hesitate to part with their money in exchange even for the best securities without the facility of reselling same in case of necessity. The government of a country is in a position to float loans easily through the medium of the Stock Exchange. In its absence, the State would experience a great difficulty in borrowing money.

Many commercial and industrial schemes would be starved for a lack of ready flow of capital without the invaluable services rendered by the Stock Exchange. A person with a small income can practise thrift in the expectation of getting an income from his investment when his bank balance accumulates to a decent figure. A person can also make an investment in a good security in the hope of making money through a rise in the market value of the security. The knowledge of ready convertibility of the securities into cash in case of necessity acts as a powerful inducement for people to make investment

in the securities of well-known concerns of sound financial standing. In fact modern industrialism owes its progress and present position largely to the facilities provided by this excellent institution. Joint-stock enterprise would not have been possible without the existence of the Stock Exchange institutions.

The rapid increase in national wealth is in a large measure due to the services of these institutions inasmuch as they ensure the sufficiency of funds for the various business and industrial concerns. Thus the Stock Exchanges have rendered a great help to the material progress of the world. These markets facilitate the purchase and sale of securities at their real values. The real value of a security depends on its dividend-earning capacity, on its future possibilities and on the degree of risk behind it. The dealers on the Stock Exchange are very well informed with regard to the conditions relating to the securities, e.g., their risks, future prospects, etc., and thus the current Stock Exchange quotation is a fair measure of the values of such securities.

It is not, however, always true; because speculation and gambling play a large part in determining the market price of stocks and shares. False rumours are spread at times to change the tone of the market and to induce hesitating purchasers to buy or to cause nervous holders to dispose of the securities. Owing to many extraneous and non-economic reasons, the market prices of securities bear little relation to their real values and many times the uninformed investors are left "to hold the baby". In other words, they purchase securities at prices which bear little or no relation to their intrinsic worth. These divergences may be temporary only; because sooner or later, the real situation must come to light; but in the meanwhile the uninformed investor has to lose a good deal. In the long run the inevitable adjustment takes place and their market prices tend to approximate to the real worth of the securities. At any particular time, the investing public and the market operators have an approximately accurate idea with regard to the yield which should be obtained from the various classes of investments. The best or the gilt-edged securities give some yield; while the yields of other securities are judged with reference to those of the *gilt-edged securities*. Thus in the long run, the prices of existing securities and of new securities tend to the level at which the yield in all cases is approximately the same.

THE LONDON STOCK EXCHANGE

The importance of the share and stock markets necessitates some description of the organization and working of a

few important Stock Exchanges of the world. The London Stock Exchange is a very highly organized stock and security market. Its origin can be traced to the speculative mania between 1726 and 1800 ; and the foundation of the building of the London Stock Exchange was laid in 1801. Subsequently, it passed through many vicissitudes and gradually acquired its present position. Its services during the war were excellent, when huge sums of money were raised to carry on the war.

The London Stock Exchange is in reality a building, vested in certain proprietors, which is used as a market for stocks and shares. The proprietors or the shareholders meet there to deal in securities according to the rules laid down by the Committee for General Purposes and by the Management. It is not regulated by any charter or statute, and its business is subject only to the regulations as laid down by the Committee for General Purposes. Thus its prestige and authority depend entirely upon the reputation it has established for the efficient and honest business methods.

It is a voluntary association of persons called proprietors holding shares in a capital or stock of £ 240,000 divided into 20,000 shares. The administration of the Stock Exchange is vested in two bodies, having separate and special functions of their own. One body consists of the Managers, who are representatives of the shareholders. They are the governing body of directors, and consist of nine members. They are elected by the shareholders and three Managers retire once in every five years. They regulate admission moneys, appoint all officials except the secretary and the official assignee, and generally manage and control the building.

THE COMMITTEE FOR GENERAL PURPOSES

The Committee for General Purposes consists of 30 members, who are elected by ballot by the members annually on the 25th of March. Members of the Committee must have been members of the Stock Exchange for a period of five years immediately preceding the day of election. Every member is entitled to vote even though he has not paid his subscription. The occasional vacancies are similarly filled by a ballot of members and the members so elected are to hold office up to the 25th of March following. The functions of the Committee are as follows :—

"The Committee regulate the transaction of business on the Stock Exchange, and may make rules and regulations, not inconsistent with the provision of the Deed of Settlement, respecting the mode of conducting the ballot for the election of the Committee and respecting the admission, expulsion, or suspension of members and their clerks and the mode and

conditions in and subject to which the business of the Stock Exchange shall be transacted and the conduct of the persons transacting the same, and generally for the good order and government of the members of the Stock Exchange. Moreover, the Committee are entitled from time to time to amend, alter, repeal such rules and regulations or any of them, and may make any new amended or additional rules and regulations for any of the above-mentioned purposes.¹ The Committee elect their own chairman and a Deputy-Chairman and also their secretary. The latter holds office during the pleasure of the Committee.

The Committee have wide powers and they can expel a member, who violates any regulation ; who may fail to comply with the decision of the Committee ; or who may be guilty of disgraceful conduct. They can also expel a member who may act in a manner detrimental to the interests of the Stock Exchange. Members of the Stock Exchange cannot take their cases to law courts without the previous consent of the Committee.

MEMBERSHIP OF THE LONDON STOCK EXCHANGE

There are about 5,000 members of the London Stock Exchange. A candidate for membership must be recommended by three members of four years' standing. The latter stand as sureties up to the extent of pound five hundred each. The entrance fee is five hundred guineas and the annual subscription amounts to 30 guineas. In the case of certain members, who have been clerks in the House or the Settling Room for four years, only two recommendations are necessary. The entrance fee is also a bit lower.

Any candidate who has been a bankrupt more than once is not entitled to become a member of the London Stock Exchange. The candidates have to purchase a certain number of qualification shares, which must be done within six months of the election. The members of the London Stock Exchange are called *Jobbers* and *Brokers*, a feature peculiar to the London Stock Exchange only. A jobber cannot act as a broker and vice versa. Stockbrokers act as intermediaries between the public and the jobbers, and are liable as agents for their clients. The outside investors cannot have direct dealings with the jobbers and must give their orders to the stockbrokers. Stockbrokers do not usually deal in stocks for large amounts for their own profit. They generally depend for their profits on the commission which they get from the public.

¹ Poley, A. A., *History, Law and Practice of the Stock Exchange*, Third Edition, Revised, p. 30.

Jobbers buy or sell the securities on the Stock Exchange and thus they deal with the investing public through the brokers. They act on the principle of 'buying cheap and selling dear'. They make their profits by speculation in stocks and shares and from the "*jobber's turn*", which means the difference between the buying and the selling prices that they quote to the brokers for the latters' clients.

This division of membership into jobbers and brokers is a special feature of the London Stock Exchange only. It possesses many advantages. *Firstly*, it acts as a check on frauds in the interest of the public unfamiliar with the methods of the market. "Were an outside buyer or seller to deal direct with a market professional, he would be entirely at his mercy, whereas by employing another market professional to deal for him he brings into play the principle of diamond cut diamond. It is quite easy to bid on one's behalf in an auction room, but it is usually found more profitable to pay a commission to some one who knows the ropes ; and the intricacies of auction buying are not to be compared with those of transactions in stocks and shares."² The system also affords a great convenience because it saves a great deal of time and effort. A very large number of securities of an international character are transacted on the London Stock Exchange, and different jobbers specialize in different securities. The brokers know whom to approach for quotation for a particular security. Hence the system provides a great convenience.

THE BUSINESS OF THE STOCK EXCHANGE

The business dealt with on the London Stock Exchange consists of the loans of British and foreign Governments, debentures, the stock of private bodies, *e.g.*, County Councils, and the debentures, stocks and shares of public companies, and options.

A person has to be introduced to a broker, if he wishes to deal on the London Stock Exchange. When the account is opened, the broker will receive orders from his clients and will place them with the jobbers on the best possible terms. The outside public cannot be admitted to the Exchange and no member of the Exchange can have any dealings with outsiders except through the brokers. The transactions may be either for "money" or for "account". In the former case, the transaction is settled and paid for on the same day ; while a transaction for "account" is to be settled on the next settling day, when the securities agreed to be purchased or sold are to be delivered and paid for.

² Charles Duguid, *The Stock Exchange*, pp. 33, 34.

When the broker receives his clients' order, he asks the jobber to quote a price for the security concerned without letting him know whether he wants to buy or to sell it, for that might tempt the jobber to vary the price a little. The jobber would not, of course, give an "out-of-the-way quotation" as the broker knows the market price almost as well as the jobber does, but he might vary the price by a fraction. As it is, the jobber quotes two prices, one at which he will sell and the other at which he will buy. Suppose it were the deferred stock of company X; and the jobber might quote 100-101, meaning that he would buy the stock at 100 or sell it at 101. This quotation might be subject to haggling and bargaining, and eventually the quotation may be $100\frac{1}{4}$ - $100\frac{1}{2}$. The broker being satisfied with the quotation may act as a buyer for so much stock at $100\frac{1}{2}$. This does not mean that the jobber would deal in any abnormal amount of stock, and there are limits for this purpose. The transaction would then be noted both by the jobber and the broker in their respective note-books. The price at which the business has been done will then be marked on a *board* provided for the purpose, so that the same may appear in the next edition of the *Official List*.

The broker will then forward a *contract note* to his client. This note bears the date of the transaction, the name and address of the broker, and the statement that the stock has been purchased at the price indicated. The client has also to pay brokerage, stamp duty and registration fee, for which there is an item in the contract note.

Transactions for account are to be settled at the next settlement day. The Stock Exchange settlement extends over four days: (1) the Mining Contango Day, (2) The General Contango Day (these days are known as continuation or carrying over days), (3) the Ticket or Name Day, and (4) the Settlement or Pay Day. The Contango Day is the day on which members, who wish to postpone settlement of their bargains, carry them over to the following settlement. On the Ticket Day, the purchaser has to give a ticket to the seller of the security. This ticket bears the name and amount of the security, the name, address and description of the transferee, that is, the buying member's client, the price, the date and the name of the member to whom the ticket is issued. This ticket is a demand for the delivery of the security purchased. On the third day the securities are delivered and paid for.

There is a *special settlement* fixed by the Stock Exchange Committee for the bargains in the scrip and securities of a new loan or a company. Before the Committee fixes this day, the new company, in whose shares the bargains have to be settled,

has to comply with certain formalities to the satisfaction of the Committee.

SOME TECHNICAL TERMS

Bull.—The Bull is known as *Tejiwalla* on the Bombay share bazaar. He is an operator on the Stock Exchange who buys stocks or shares in the hope that there will be a rise in their value before the next settling day and that by taking delivery at the cheaper rate at which he has agreed to buy, and delivering the same at the higher rate, he will make a profit. If a speculator thinks that the price of certain shares quoted to-day at Rs. 100 each is likely to go up by the next settling day, he agrees to buy 10 shares on account. In case the price goes up to Rs. 110 per share, he can make a profit of Rs. 10 per share *minus* brokerage inasmuch as he can take delivery at Rs. 100 and sell them at Rs. 110. The Bull is thus optimistic and he believes that the price will rise.

Bear.—The Bear is known as *Mundiwalla* on the Bombay share bazaar. He sells stock, which he has not got, in the hope that he will be able to buy it at a lower price before he is called upon to deliver it. He is thus pessimistic and believes that the price of the securities will fall. Having sold stocks or shares which he does not hold, he is anxious that there should be a fall in their price, so that by the next settling day, he may be able to buy them at a lower price and thus realize a profit. If he agrees to sell certain shares at Rs. 100 per share on the next settling day and if at that time, their prices register a fall, say, to Rs. 90 per share, he can make a profit of Rs. 10 per share *minus* brokerage by taking delivery at Rs. 90 and selling same at Rs. 100.

Stag.—The Stag is a speculator on the Stock Exchange who applies for shares in a new company in order to sell them at a profit. He never intends to hold or eventually subscribe for the shares. The ordinary applicant who is not a Stag applies for securities to keep as an investment. When the securities are to be in great demand, the Stag frequently applies for them for a larger allotment than he could possibly pay for. He assumes that only a small proportion of the total applied for will be allotted to him and, if he can sell at a premium the more he is allotted the better for him. The existence of a large number of stag transactions shows that the price of the securities will fall soon after they are issued, although at the time of issue, the demand may be enormously in excess of the supply. This fall is caused by the steady selling of securities by the Stags, who had formerly created a fictitious demand for them.

Carrying Over.—This is a term applied to the arrangement by which the parties to a Stock Exchange bargain

postpone payment or delivery by continuing the transaction into the next account. If a Bull finds that the prices of the securities which he has agreed to purchase have not registered an advance, he can continue the bargain as he certainly does not desire to pay for them. The actual process of arranging this lies in selling out the security and then repurchasing it, both the sale and the repurchase being done at the making-up price. It is fixed at each settlement by the clerk of the House. If the current price on the settling day is 98-99, the middle price will be the price for such carrying over. The original contract will thus be cancelled at 98½, and the difference between the making-up price and the price at which the Bull had purchased the security, that is, 1½ per share, has to be paid by the Bull to the jobber, and a new contract for purchasing the same securities is entered into at Rs. 98½ per share. In the case of the Bear, having sold stock he does not possess, he is able to continue his bargain ; because he has no intention of giving delivery at the settlement. If the price has gone up, the Bear has to pay the difference between the price at which he bought and the settlement making-up price. Further, to enable him to go on to the next settlement, he has, as it were, to borrow stock.

Contango.—A Bull who carries over his bargain obtains advantage because he is allowed to postpone payment for the security purchased up to the following settlement, and for this facility he has to pay a charge known as contango. This is absolutely different from the difference that he has to pay between the making-up price and the original purchase price. The contango rate is also referred to as a rate of interest; though it is not wholly of the nature of interest inasmuch as the carrying over does not merely consist in postponing payment, but it also postpones delivery of the stock. This charge varies with the rate of the money market, or with the market conditions in that stock.

Backwardation.—The allowance made by the seller to the purchaser is known as Backwardation. There is usually a backwardation when the speculative sales have been more than the floating supply of the stock. The Bears are then obliged to pay back in order to borrow the stock in place of receiving interest on their money, which they practically advance against the stock. It is a sort of penalty imposed by a Bull clique upon the Bear when sales have been made in excess of the stock on the market.

When the demand of the buyers for loans to pay for the stock they have bought is balanced by the demand of the sellers for the same stock which they have undertaken to deliver, there is neither a contango rate nor a backwardation rate.

Under such circumstances, the buyers or the sellers have to pay nothing for carrying-over, and the rate then is called *even*.

The existence of a big Bull account or a big Bear account has an important effect upon the market. The former course weakens it and the latter one strengthens it. Every Bull is a prospective seller and every Bear a prospective buyer. Thus prices may rise while the Bulls are purchasing ; and they may fall while the Bears are selling ; but sooner or later the movement in the opposite direction must begin.

Bull Campaign.—When the Bulls by concerted action disseminate stories favourably affecting the stock, they may bring about a '*rig*'. The artificiality of this state of the market becomes evident when the time for selling comes in. The position may become delicate from the point of view of the Bulls ; and consequently, some Bulls may be compelled to close their accounts at a loss. They are known as *Stale Bulls*. Thus a *Stale Bull* is one who has held on for some time without an opportunity of realizing a profit.

Banging a Market.—By concerted action, Bears may openly offer securities at decreasing prices in order to lower down their prices. By spreading such news, the prices may actually be brought down to a level not warranted by the intrinsic worth of the securities. This is known as *Banging the Market* or *Bear Raid*. At the end of the raid, the position of the Bear becomes very awkward. He may find it exceedingly difficult to obtain the stock which, having sold, he has undertaken to deliver. Prices begin to rise and the *Bear Covering* or *buying back*, only enhances this upward trend of prices. The stock then may be unobtainable ; the bears are then *cornered*. Unless a bear so situated makes terms with the party to whom he has sold the stock, or with some one else, he cannot meet his engagement. He is then known as a *Lame Duck*.

Buying-in and Selling-out.—These expressions are frequently used on the Stock Exchange. If the securities are not delivered within the time limits fixed by the Committee the buyer can give an order to his broker to buy in against the jobber, and similarly, a seller can sell out if he does not receive a name in order to complete the sale. This is done through the officials of the Buying-in and Selling-out Department of the London Stock Exchange. These officials are appointed by the Committee for General Purposes, and they must do the buying-in or selling-out publicly. These securities will not be bought-in, if they are out of the control of the seller for the payment of calls or the receipt of interest, dividends, etc., and on being applied, the Committee will fix a day for this purpose. The Committee can suspend the buying-in of securities, when they regard such suspension desirable in the general

interest ; and during such suspension, the liability of intermediaries continues unless the Committee determines otherwise.

Options.—This is a method of speculating under which the gains are left unlimited, but the loss is limited to the amount paid for securing the option. They are of three kinds ; the put option, the call option and the put and call or the double option. The *put option* entitles its possessor to sell to the other party a definite amount of stock at a certain price. If a speculator thinks that the price of certain shares, with a face value of Rs. 100 each, is likely to fall, he may agree to sell 10 shares at Rs. 100 each and he will pay, say, rupee one as option premium. If on the next settlement day, the price falls to Rs. 90 per share, the bear speculator can get a difference of rupees ten per share *minus* the option premium. Thus on the ten shares, he makes a net profit of rupees ninety. In case the market value were to go above Rs. 100, he would not exercise his option and lose the option money. The *call option*, on the other hand, is the option to purchase securities. This is exercised by a bull speculator. In case the price of the security rises, the profit of the speculator consists of the excess of the market price over the price at which he had agreed to exercise his option *minus* the option premium. Suppose that A exercises his option for purchasing 10 shares of Rs. 100 each and pays rupee one as option premium per share. If the price on the settling day rises to Rs. 110 per share, his profit consists of Rs. 90 ; whereas if the price goes down to Rs. 90 per share, he would not exercise his option and would merely lose the option money.

Put and Call Option or Double Option.—The double option entitles its possessor to exercise the option either way at the prices fixed for the put and call options respectively. In this case he has to pay double the premium. These transactions are entered into only for those securities whose prices are subject to violent fluctuations.

Call of More.—This combines a Bull transaction *plus* a call option transaction for an equal amount. When a speculator thinks that the price of the security in which he wants to deal is likely to go up before the next settling day and he does not want to take a great risk, he may act as a mere bull speculator for, say, 10 shares and can exercise call option for another ten shares. If the price goes up to Rs. 110 per share, his profit consists of Rs. 190, that is, Rs. 100 on the Bull transaction and Rs. 100 *minus* Rs. 10 on the call option transaction. On the other hand, if the market were to move against him, say, the price goes down to Rs. 90 per share, his loss comes to Rs. 110 only, that is, Rs. 100 on the Bull transaction and the loss of option money on the call option transaction.

Put of More.—This transaction combines a Bear transaction together with a put option transaction.

The Cover System.—In the case of this type of transactions, so much per cent. or per share is given to a broker by a speculator with instructions to enter into a Bull or Bear transaction, the implication being that if the prices move against the speculator and the loss comes up to the cover money, the transaction is to be closed. Thus the loss never exceeds the cover money. In case the speculator wants to wait, he has to deposit an additional amount of money. If the market moves in favour of the client, the cover money is refunded with the profit. It may be remarked that the option money is not returnable in any case, and herein lies the difference between an option transaction and the cover system.

Amortisation.—This term signifies the redemption of bonds, shares and other commercial paper or securities by means of annual drawings from a sinking fund, or the complete repayment of a loan by a single payment out of some special fund set aside for the purpose. The interest on such bonds withdrawn is added to the sinking fund, thereby increasing the next amount amortized. The repayment takes place by drawings at par or sometimes by purchase in the open market. Generally, amortisation takes place once or twice a year.

Authorised Clerks.—These clerks are authorised according to the rules of the Stock Exchange to transact business on behalf of their principals on the Exchange; while *unauthorised clerks* are those who accompany their masters on the Exchange in order to check the bargains for them and to assist them generally.

Averaging.—This term is used on the Stock Exchange to denote the operation of buying or selling stock, to reduce the average loss upon an original bargain when the price of the stock goes against the operator. If £ 500 of stock is purchased at 90 for the rise, the buyer paying £ 450, and the stock falls to £ 84, the buyer can buy an equal amount of stock at £ 84. Then he has the stock at 87. In the event of a rise, he can clear his purchase at a little over 87, thus avoiding a loss.

Balance Certificate.—When a holder, possessing a single certificate for the lot, sells a portion of his shares, the company in receiving the deed of transfer and the certificate makes out a certificate of the transferred shares and a second certificate for the balance which is retained.

Boom.—A period of extraordinary activity with a rising tendency of prices.

Bucket Shop.—This is a slang term used to denote the offices of outside brokers.

Close to Close.—This is a price made by jobbers when dealing $3\frac{3}{4}d.$ or $1/64$ either side of a price. For instance, $1/16$ to $\frac{1}{2}$ close to close means $1s. 6\frac{3}{4}d.$ to $2s. 2\frac{1}{4}d.$, at which prices the jobber would be prepared to buy or sell.

Consolidated Annuities.—This is a term applied to the consolidation of annuities into one common debt.

Consols.—A combination of the terms consolidated funds and consolidated stock.

Corner.—This term refers to the operations of speculators through which they obtain the whole or the greater part of the floating stock. The Bears are then forced to buy back the shares at the price that the Bulls allow them. The Bears are then cornered. If the Bulls keep a tight hold on the market and the prices rise in such wise that the Bears are obliged to pay heavily for securing them, they are then said to be *squeezing the Bears*. When the Bears succeed in bringing about a fall in the prices of securities, it is spoken of as a *Bear Raid*.

Cum Dividend.—When the price quoted includes the dividend that has been declared or is about to be declared, it is known as *cum dividend*.

Ex-Dividend.—Means without dividend.

Cum Drawing.—The term refers to the dealings in bonds at or near the time when the drawing takes place. The securities are sold with any benefits that may arise from the drawing, and the buyer receives the profit if they are drawn for repayment at par or at a premium.

Cum New.—*Cum Rights.*—When successful joint-stock companies issue a fresh batch of shares, the same can command a premium in the open market. The existing shareholders are usually given the right to claim any new shares that may be issued. Such shareholders can sign a *letter of renunciation* and thereby sell their right to the allotment of these new shares in the buyer's favour. The existing shareholder can then secure the premium on the new shares without incurring the liability for payment of their amount to the company. When the original shares are sold with the right to claim the allotment of the new shares, they would be sold *cum new* or *cum rights*.

Ex-all.—These words signify that the dividend, bonus, return of capital or right to claim new stock is retained by the seller.

Floater.—Bearer securities accepted as securities for loans.

Gilt-edged securities.—Securities that are considered to be absolutely safe as means of investment.

Investment Stocks.—Securities selected by the buyers as means of permanent investment.

Limited Market.—Where there is a difficulty of doing business freely.

Plunger.—A reckless speculator.

Rig.—“*Rigging the Market*” means the forcing up of the market value of a security without any reference to its real value.

Sag.—The slow dwindling of the prices of securities owing to an absence of business.

Script.—It is a kind of certificate containing the number of bonds or shares taken up by the subscriber, a receipt giving the amount paid by the subscriber for the first instalment. The amounts and dates of the instalments yet to be paid are also given. It is exchanged for the bond on payment of all the instalments.

Selling Short.—The term refers to the case of *short sales*. Speculators are said to be short of stock when they have sold what they do not possess.

Shake out.—The term refers to a temporary reaction in a rising market and it denotes the shaking out of weak Bulls.

Taking-in Stock.—Taking in stock and giving on stock are the reverse positions of people who arrange a contango. The Bear is the taker and the Bull is the giver. Money-lenders who advance money for the account on stocks and shares are the takers-in. In continuation or carrying-over, the taker-in of stock becomes the purchaser for the current account and he is bound to deliver back a like amount of stock on the ensuing account.

Tape Prices.—This term refers to quotations on the Stock Exchange as recorded on the tape of the instruments of the Exchange Telegraph Company.

Time Bargain.—This term means a contract for the future delivery of stock, the value of which cannot be ascertained. It also refers to a contract for differences on the Stock Exchange.

THE BOMBAY SHARE BAZAR

The official designation of the Bombay Share Bazar is the Indian Share and Stock Brokers' Association. Formerly, only the natives of India could become its members, but now admission is thrown open to others also. The Bombay Stock Exchange Enquiry Committee in 1923 made the following recommendations regarding the business methods and practices of the Bombay Stock Exchange:—

(1) There should be a change in the policy of the Association regarding corners.

(2) Failing the above, all forward dealings in stocks and shares in the City of Bombay were recommended to be prohibited by legislative enactment.

(3) The old rules empowering the Association to interfere and fix rates in case of a contemplated or existing corner in any of the scrips dealt in on the Bombay Stock Exchange were recommended to be abolished as in the opinion of the Committee they were mere palliatives.

(4) Suggestions were also made for the modifications of rules relating to the powers of the Committee of Management, holidays, closing of the Exchange for settlement, marking of bargains, etc.

The Bombay Securities Contracts Control Act was passed in 1925 which applies to the whole of the Presidency of Bombay. Any Stock Exchange can now apply to the Governor-in-Council for recognition and when so recognized, the same has to make rules subject to the sanction of the same authority regarding the control and operation of the Exchange, powers and duties of the governing body, settlements of disputes between members, punishments of defaulting members, etc. Every contract for the purchase and sale of securities except a ready delivery contract is to be void unless the same is subject to the rules referred to above and that too between the members or through members of a recognized Exchange. No claim for fee, commission, etc., is to be allowed in any Civil Court in the case of such void contracts.

BOMBAY STOCK EXCHANGE RULES

Natives of India and British subjects having resided in the Bombay Presidency for the last ten years preceding the date of membership can become members. A candidate for membership has to be recommended by two members of at least five years' standing. None of the two recommending members should be a member of the Board of Directors. The candidate should obtain a nomination in place of a retiring member, or he may apply against a card in the hands of the Board of Directors. The election is by ballot and should be carried by a majority of not less than three-fourths of the members present, at a meeting of the Board of Directors which must be attended by not less than one-half of the total number of members of the Board. The annual subscription is Rs. 5 and the entrance fee is Rs. 30,000 in the case of a member other than the one nominated.

The Board can exercise disciplinary powers of expulsion under the following cases :—

- (1) Unworthy conduct, conviction for any criminal offence, breach of rules, etc.
- (2) A member of the Board having a direct or indirect interest in a syndicate bear or bull, except as a broker, can also be expelled.
- (3) When a member is adjudged insolvent.
- (4) Fines can also be imposed upon a member for any breach of regulation by a resolution of the Board of Directors.

CARD OF MEMBERSHIP

The right of membership as indicated by the Card is entirely a personal right and cannot be assigned, pledged or transferred to any one else. The card along with all the rights and privileges of membership vests in the Association when a member is declared insolvent. The Board of Directors can dispose of it in any manner they deem fit. The proceeds of the sale of the card have to be applied in the first instance to satisfy the liability of the member concerned and the balance goes to the funds of the Association.

AUTHORISED AND UNAUTHORISED CLERKS

A member of the Bombay Stock Exchange can employ four authorised clerks, who must not be members of the Association. A partnership firm can employ 7 authorised clerks. These clerks can make bargains on behalf of their employers in the latters' name. The members are liable for all bargains made by such clerks on their behalf. Authorised clerks wear a badge of the Association. Unauthorised clerks are not entitled to admission to the Stock Exchange Market in Bombay.

ARBITRATION COMMITTEE

The Arbitration Committee consists of sixteen members. Under the rules of the Association all disputes are to be referred compulsorily to it. The Committee appoints two of its members as arbitrators from whose decision there is an appeal to the Arbitration Committee within seven days of the receipt of the award by the parties concerned. The decision of the Arbitration Committee is final and binding on the members of the Association; but where the dispute is for Rs. 1,000 or more, there is an appeal to the Board, whose decision is, of course, final.

DEFALTERS' COMMITTEE

The Defaulters' Committee, consisting of six members deals with the cases of those members who have been declared as defaulters in the open market and who are unable to fulfil their engagements on the Stock Exchange. A member is declared as a defaulter by the Board on application from a

creditor of the defaulter, or on receipt of a complaint from the Clearing House. An insolvent person is *ipso facto* declared a defaulter. This Committee investigates into the state of affairs of the defaulting member and calls upon him to file a written statement containing a list of his assets and liabilities. The assets are then distributed by the Committee *pro rata* among the creditor members of the Association according to their admitted claims.

In case of a *Bear Raid* when prices of shares or stocks are unduly depressed on account of reckless short sales, the Board can suspend all forward business by a resolution of not less than one-half of the members of the Board at a special meeting at which not less than three-fourths of the total members are present. All transactions before the date of suspension must be settled by delivery of securities and by payment of money on the settling day, unless the Board extends the time therefor by a resolution in like manner. It may be mentioned that the Bombay Stock Exchange Enquiry Committee had recommended that the short sellers should be left to pay the penalty in the absence of fraud and that contracts involving purchase and sale of securities should be settled by delivery of shares and by payment of purchase price.

CLEARING HOUSE

The Bombay Stock Exchange has a Clearing House like the principal Stock Exchanges of the world. Its main function is to "act as the common agent of the members in settling transactions between them by giving and taking delivery of securities and making and accepting payment for the same and clearing the differences." Its main obligation is to facilitate the transfer of securities and documents in relation thereto between the purchasing and selling members. Only the members have a right to settle contracts through the Clearing House. All forward bargains in certain specified securities are to be cleared through the Clearing House.

SUMMARY OF MAIN FUNCTIONS OF STOCK EXCHANGES

It is thus clear that Stock Exchanges are institutions which render the capital of a country more efficient than it would be otherwise. Their main functions may be summarised below :

- "(a) They make investment easy.
- (b) They make withdrawal from an investment easy, and, in so doing, make capitalists more disposed to invest.
- (c) They bring together all classes of investments, make clear their disadvantages, and so appeal to all classes of investors, e.g., those who wish above

all security ; those who demand a chance for large returns ; those who can wait indefinitely for returns of any sort, etc.

- (d) They make the properties represented in stocks and bonds perfectly available as a basis for loans. (Banks will readily accept such bonds and stocks as security, seeing that there is a continuous and unlimited market where these properties can be disposed of at almost any moment.)
- (e) It is worth noting that the stock market furnishes government with the best available clue to the value of corporate properties when these are needed for the purposes of taxation or social control.”³

MAIN ADVANTAGES

(a) The Stock Exchanges give mobility to capital. In their absence, the securities of business concerns could not be placed to advantage in markets. The mobility of capital would be meagre, if the holder of securities did not know that he could take them to the Exchange and sell them. The publicity at the Stock Exchange enables the holder of the security to know the opinion of the most competent financiers.

(b) They afford a test of the utility to the community of the concerns which solicit the support of the investors. When the investor finds that the shares of a certain concern are going up in value, he knows that the public has a great demand for such concerns and that an investment in them would prove profitable. The investor gets all this information in the form of a carefully prepared table.

(c) The Stock Exchange Market is the great governor of values. It is a guide which points the finger to where the capital is greatly in demand and where it is not. In the absence thereof a great misdirection of capital and energy would take place.

(d) The Exchange exerts a very important influence upon the money market. The possession of a large mass of saleable securities provides a guarantee against a severe money panic. The banks can call in loans when there is a sudden pressure for money. The holdings of foreign securities can be sold at a moment's notice and gold would begin to flow in. Thus at certain times crises can be prevented, or their force can be broken when they can be anticipated, if they cannot be prevented.

It cannot, however, be doubted that these benefits do not always flow from the Stock Exchanges. As has been noted

³ Marshall, *Industrial Society*, p. 266.

already,⁴ they sometimes lead to speculation of the worst type, which might eventually lead to trade crises and financial panics. They encourage gambling and bring ruin to many investors and banking institutions, who finance the speculators. A proper type of control is thus necessary if they are to be purged of their worst evils.

⁴ Cf. *ante* page 291 of this Chapter.

CHAPTER XXVII

Index Numbers

IT frequently becomes necessary to analyse movements of prices in order to discover their causes. The prices of some commodities may go up, while those of others may go down or remain stationary. Different causes act on the movement of the prices of different commodities. There may be a rise in the prices of some commodities because of a fall in production without a corresponding decline in demand, or because the demand may increase, supply remaining the same. The changes in the purchasing power of money may also bring about inverse changes in prices.¹

To find out the general level or trend of prices, the method of index numbers is resorted to. A few commodities relevant to the object in view may be selected, their prices for a particular year noted and the prices of later years of the same commodities expressed in relation to them, usually by stating them in terms of a percentage. Thus the average of the fluctuations in the prices of such commodities in terms of a percentage is called *a price index number*.

An example will best explain the construction of index numbers. Suppose that on January 1, 1929, the price of wheat was Rs. 4 per maund, of cotton 12 as. a seer, of ghee Rs. 2 a seer and of salt Rs. 1-8-0 per maund. These are called *the base prices*. Suppose that on January 1, 1932 the prices of the four commodities were : Rs. 2-8-0 for wheat, 8 as. for cotton, Re. 1 for ghee and Re. 1 $\frac{1}{4}$ for salt. Then the actual prices, and the percentage relation between them, would stand thus :—

| | 1929 | | 1932 | |
|---------------------------|------------|-----|----------|--------------------|
| | Base Price | 100 | Price | Percentage to Base |
| Wheat | Rs. 4.00 | 100 | Rs. 2.50 | 62.5 |
| Cotton | .75 | 100 | .50 | 66.6 |
| Ghee | 2.00 | 100 | 1.00 | 50.0 |
| Salt | 1.50 | 100 | 1.25 | 83.3 |
| Total | | 400 | | 262.4 |
| Average (Arithmetic Mean) | | 100 | | 65.6 |

¹ See Chapter XIII.

The index number was 400 for 1929, and fell to 262.4 for 1932. Reduced to the arithmetic mean, the index number for 1929 was 100; while that for 1932 became 65.6. This shows a fall in prices of 34.4 per cent. or, in other words, as the word "index" implies, it *indicates* a fall in prices.

If, now, instead of four commodities, a hundred or more were selected in this manner, there should be some confidence in the indication obtained as to a general change in prices. If the summarized result shows a fall of fifteen or twenty per cent. in the index number, it is fairly certain that most commodities have gone down in price. This may also be due to the fact that 50 per cent. of the commodities may have gone down in price; while the other 50 per cent. may have gone up, though only slightly. But an examination of actual changes, even a cursory one, almost always shows, where a marked change has occurred in an index number, that the large majority of prices have moved in the one way indicated. The index number serves, therefore, to point to a fact—that on the whole prices have moved in one direction.

Sometimes the *weighted arithmetic average* is used as a method of calculating index numbers. The relative importance of different articles is taken into consideration, or to put it in technical words, the articles are weighted. For instance, a change in the price of wheat is of much greater importance than a change in the price of cotton. If wheat were to double in price, the purchasing power of a given income would be seriously affected, if cotton were to double in price, much less. The varying importance of different commodities is taken into consideration in the construction of an index number by assigning weight to the commodities in the proportion of their consumption. If a community spends four times as much

| | 1929 | | | 1932 | | |
|-----------|--------|-------------|---------------|-------------|---------------------|--------------------------|
| | Weight | Base Price | Weighted Base | Price | Percent-age to Base | Weighted Change in Price |
| Wheat .. | 4 | Rs. 4.00 | 400 | Rs. 2.50 | 62.5 | 250.0 |
| Cotton .. | 1 | .75 | 100 | .50 | 66.6 | 66.6 |
| Ghee .. | 2 | 2.00 | 200 | 1.00 | 50.0 | 100.0 |
| Salt .. | 3 | 1.50 | 300 | 1.25 | 83.3 | 249.9 |
| Total .. | 10 | — | 1,000 | | | 666.6 |
| Average | | | 100 | | | 66.6 |

of its income on wheat as on cotton, the former may be counted as if it were four articles and the latter as if it were one. If twice as much is spent on ghee as on cotton, ghee may be counted two articles; while salt on a similar assumption, may be counted as three. The prices used in the original illustration would then be made up into an index number as above.

This weighted average indicates a fall in prices from 100 to 66.6; whereas the simple arithmetic average indicates a fall from 100 to 65.6 only.

Other modes of reaching the index numbers are the geometric mean, the median and the mode. The advantage of the geometric mean over the arithmetic average is 'that it tends to nullify the effects which items of very large magnitude have upon the average, and this is important when such extremes are few in number as compared with the remainder of the data.'

It is calculated in this manner: if the number of items in a series = n , the items are multiplied together and the n th root of the product is calculated. If it is desired to obtain the average of the magnitudes, 2, 3, 4, 5, 6, 7, 8, 9, 10 and 181, the arithmetic average would be

$$\frac{2+3+4+5+6+7+8+9+10+181}{10} = 23.5, \text{ a result which is not}$$

representative, because the extreme item 181 has pulled up the average very much. The geometric mean would give us the following:—

$$\sqrt[10]{2 \times 3 \times 4 \times 5 \times 6 \times 7 \times 8 \times 9 \times 10 \times 181} = 7.6164 \text{ thus bringing the average within the range of the majority of the examples in the data, and so making it more representative. The geometric mean is always lower than the arithmetic average. It is very difficult to calculate, and unless some of the extreme items are of considerable magnitude, the results do not very much differ from those obtained from the use of the arithmetic average.}$$

The median is obtained, not by averaging, but by ascertaining midway points. The several price quotations for any year (reduced to a uniform basis as in other methods) are arranged in numerical order, and the figure standing in the middle of the series is picked up. This is how the index numbers are made up by the use of the median.

It has been found by experience in the application of the various methods to the same sets of figures that the simple arithmetic average when applied to a fairly large number of price quotations, gives substantially the same results as more refined methods. When there are a very large number of

articles in the list, some of much importance, some of little, it is unlikely that the prices of all the important articles will fluctuate in one direction, while those of all the unimportant ones in another. If they did so, weighting would be very necessary. But it is very likely that the fluctuations would be distributed among the several classes in much the same way. 'An unusual change in the price of a particular article, whether it be consumed in large amounts or in small, will not affect greatly an average made up from many price quotations. And in practice it has been found that the simple unweighted average brings results not very different from those obtained after weighting.'

Certain precautions must be taken in the construction of index numbers. Firstly, the base period should be free from abnormalities. In place of a particular year, a period of ten years may be selected as the base year. The *Statist* in England bases its comparison upon the prices which were ruling in the years 1867 to 1877; while the *Economist* originally based its number on the average prices ruling during the period 1845 to 1850. But when the index number was revised in 1911, the average prices ruling during the period 1901 to 1905 were selected in place of the original base period.

Secondly, care should be taken in the selection of the commodities the index of whose prices is to be obtained. This will depend upon the object in view. For a general price index, a large number of commodities are to be selected. The index number of the *Economist* now includes forty-four articles; while that of the Board of Trade is compiled from the prices of no fewer than 150 commodities or classes of commodities. The *Financial Times' Weekly Index Number*, calculated on the Chain Base Method, consists of 73 items.

Thirdly, the selection of the wholesale or the retail prices is also important. According to the Bowley-Robertson Committee Report, "The main uses of index numbers of wholesale prices are in relation to national, not to local, economic problems, and for the study of general tendencies. They are considered in relation to the movement of currency, exchange, of wholesale prices in other countries, and of indices of production, wages, retail prices, etc., in each country. Further, they form one of the most important indications of the general movement of the trade cycle through its various phases."² But in the case of the *Cost of Living Index Number*, where an endeavour is made to obtain an indication of the effect of the change of prices upon the cost of living, the retail prices must be used.

² Bowley-Robertson Committee Report: *A Scheme for an Economic Census of India*, 1934, p. 44.

Retail prices vary in different localities and the standards of living of different classes of people also differ in the same place. In the cost of living index number, therefore, only those commodities should be used which enter into the consumption of the class of people whose cost of living is to be estimated.

In England, the principal effort to construct a Cost of Living Index Number is that of the Ministry of Labour; and this was the basis of many of the claims for increased wages made by the English labour organizations during the war. The object of this Cost of Living Index Number is to measure the average increase in the cost of maintaining the Pre-war standard of living of the Working Classes in England. The items included in the statistics fall into five main groups, viz., (1) Food; (2) Rent; (3) Clothing; (4) Fuel and Light; and (5) Sundries.

USES OF INDEX NUMBERS

Index numbers can be put to various uses. The Cost of Living Index Number in England has been the basis for adjustments of wages in various trades in that country. Whenever there is a difference of opinion between the representatives of labour and those of capital regarding the payment of wages, the matter can be settled by the help of the cost of living index numbers. In such cases, the retail prices of those commodities which enter into the consumption of the working classes in a particular locality should be taken into consideration.

The Bankers' Magazine in England compiles an Investment Index Number which is of great help to those interested in the Stock Markets. The basis of the number was the capital and market quotations on December 31, 1921, and the average prices of each group were equated to 100. The average market value for any particular date can then be compared with the base figure, and the percentage of increase or decrease ascertained.

The wholesale price index numbers indicate the general trend of prices. The quantity of money in circulation can be regulated with reference to such index numbers. If the index number of wholesale prices shows a rise, the natural corollary is that there has been a fall in the value of money. This may be due to the excessive supply of money which can be adjusted properly.

Index numbers can also be used to gauge the progress of a particular business concern or of a number of business concerns in a certain industry. The increase or decrease in the index number for a particular year can be compared with the number 100 for the base year. Similarly, they can be used for almost all economic, commercial and financial problems. The trend

of the trade, capital, profits, etc., can all be gauged with the help of index numbers.

DRAWBACKS

There are certain drawbacks of index numbers. Firstly, it is very difficult to select a base period which is absolutely free from abnormalities. Secondly, the comparison of prices over several years is rendered difficult because articles change considerably in description and quality. It may be said that this factor is less marked in the wholesale than in the retail markets. Thirdly, index numbers do not provide a correct method of comparison of the price-level in different countries, because the base year, the selection of commodities, etc., in various countries are different.

In spite of the difficulties enumerated and the various objections which are made to the use of price index numbers, it is found that the results obtained by various methods can be relied upon. Index numbers are at best only approximate. They are not intended to be absolutely accurate, but merely an approximate indication of the trend of prices over a given period of time. They have proved very beneficial to the economist and the politician, to the business organizer and the statesman alike.

INDEX NUMBERS IN INDIA

The main sources of index numbers of wholesale prices in India are the *Indian Trade Journal* and the unofficial publications. They appear to give all practicable information about the detail of movement of wholesale prices in the larger towns. The local wholesale price index numbers for Calcutta, Bombay, etc., do not seem to be serving any good purpose.³

The existing general index number of wholesale prices in India is unsuitable for its purpose. The figures are expressed as percentages of the year 1873; the list of commodities has not been revised since 1889 except for slight alterations in the choice of quotations. It includes certain commodities like indigo which are no longer of importance, and it is unweighted. According to the conclusions of the Bowley-Robertson Committee Report, "...a new index should be constructed at once on the model of that of the Board of Trade. The distinction between prices of Imported and Exported goods....should be dropped and replaced by categories similar to those in Great Britain (Food, and Non-Food, with sub-division into Cereals, etc., in the first, and Minerals, Textiles, etc., in the second)." The adoption of the geometric mean in place of the arithmetic average is recommended by the experts. It is also suggested

³ See *ibid.*, p. 44.

that in the first instance the year 1926 or 1927 should be chosen for equation to 100, because the rupee exchange on London did not settle down till 1926, and this is *prima facie* a good date to select.

Regarding market wholesale prices of agricultural produce, it is recommended that attention should be given to exact description of the grade, and the statements should be for particular days and not averaged over a period.

RETAIL PRICES

It is clear that retail prices vary greatly from village to village and even within a city, and that there are many grades with the same general name for which there are different prices. These variations alone necessitate the ascertaining of prices at the same places year by year for the purpose of averaging. The same grade and condition of each commodity should be priced in each record for the same place. "The returns appear to be made in the market towns in a perfunctory manner, and there is no security that they are comparable from time to time and place to place." It is unnecessary to collect these prices at very frequent intervals at a great number of recording stations, and the great multitude of returns makes supervision difficult and probably ineffective.

In this connection, the Bowley-Robertson Committee recommend that "instead of a double system of weekly and monthly reports, the prices should be ascertained on one day only in each month (as is the custom of the Ministry of Labour in England) from a relatively small number of towns of various sizes in each province. Not only should the grade and place, shop or market be rigidly defined and adhered to, but also the nature of the transaction (method of sale, unit of account, etc.) that is the subject of report should be unchanged from month to month. Even the time of day should not be varied."⁴

For index numbers of retail prices the Committee recommend that they should not be computed for separate provinces, but that data should be accumulated for India as a whole. The index numbers for separate commodities must be set on a firm basis. For their combination, weighting is suggested, and it will be necessary to make estimates of the relative importance of the commodities in the personal spending of the inhabitants of India, excluding consumption not on a cash basis.

"Since the series of prices of commodities can only include articles which are exactly definable and do not change in their qualities except over long periods, the composite index will

⁴ See *ibid.*, pp. 46, 47.

relate only to food, fuel and the simpler kinds of clothing. In relation to the wholesale index number, it will indicate the effect of the cost of merchanting, but hardly at all that of manufacture."

COST OF LIVING INDEX

An All-India cost of living index number is not recommended, because it would not be representative when applied to provinces. It would be impracticable also at present to attempt a calculation for villages, where much of the consumption is not on a cash basis, and where there is considerable local variation. The measurement of changes in the cost of living is important in those large towns where wage payments are made mostly on a cash basis, in order that public opinion may be well-informed when the merits of a wage-dispute turn on the expense of living. Separate index numbers should be made for each town as is the practice at present, and they should not be averaged together.

For some towns very satisfactory numbers exist, e.g., Ahmedabad, Nagpur, Sholapur, etc. To form these numbers a group of accurate budgets is necessary. This should cover the expenditure on necessities of the working-class. The number of budgets need not be large, unless the divergence among them is very great. Weights should be applied to the categories of food, clothing, fuel and rent respectively. The resulting index shows the change in the expense of maintaining a defined standard of living, so far as ordinary necessities are concerned, for a family having an income near that of the average of those from whom the budgets are framed.

WAGES AND UNEMPLOYMENT

Accurate statistics should be obtained for wages and unemployment. There are three categories under which statistics can be suitably collected in India. (A) Factories and Mines ; (B) Other Urban Occupations ; (C) Rural Occupations. Under (A) improvement in the collection of statistics is necessary ; while under (B) very little attention has been paid for the collection of statistics regarding the wage-rates of those persons who work outside the factories in the towns. The main work should be done by Labour Offices and exact definition and comparability are essential.

Serious attention should be paid to the collection of wage-statistics relating to persons in rural occupations. A small number of villages in each district should be selected. The villages should be such where preferably a wholly cash rate is paid, and care should be taken that in each successive record the wages are paid for the same work and are strictly comparable. A great deal of construction work is necessary before attempting

a general index number for the whole of India or for the Provinces. Experiments might be made in the construction of separate index numbers under A, B and perhaps C.

Without an Unemployment Insurance Scheme or other means of registration, adequate statistics of unemployment are not obtainable. Such statistics are available in factories and mines, and variations in unemployment are fairly closely related inversely with those in employment. These figures can be extended in scope, and arrangements may be made to publish them monthly. The allied problem of labour-turnover in factories is important, but presents special difficulties in this country. Intensive studies should be made on the continuity of employment and the frequency of changes, wherever the material for them is available. Statistics of absenteeism coupled with those of unemployment throw some light on the problem.

Similarly, index numbers should be prepared relating to profits, foreign trade, balance of payments, etc., for India. In this connection, the collection of adequate statistical material, particularly relating to banking, is very necessary. It is only then that index numbers will be constructed on right lines.

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